

GENERATION-SKIPPING TRANSFER TAX

HEARING BEFORE THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

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GENERATION-SKIPPING TRANSFER TAX

TUESDAY, OCTOBER 2, 1984

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met at 10:15 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons presiding.

[Press releases announcing the hearing follow:]

[Press release No. 24, Monday, July 2, 1984]

HON. DAN ROSTENKOWSKI (D., ILL.), U.S. HOUSE OF REPRESENTATIVES, CHAIRMAN, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A HEARING ON GENERATION-SKIPPING TRANSFER TAX

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a public hearing to review proposals to simplify the generation-skipping transfer tax imposed by Chapter 13 of the Internal Revenue Code. The hearing will be held on Thursday, September 13, 1984, at 10 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

I. BACKGROUND

Chapter 13 of the Internal Revenue Code was enacted in the Tax Reform Act of 1976 along with other major revisions of the Federal estate and gift tax system. Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a distribution to a great-grandchild of the grantor of the trust where his or her parents also have been beneficiaries of the trust) or upon termination of an intervening interest in the trust (for example, a remainder interest passing to the grantor's grandchild upon the termination of a life income interest in the trust held by the grantor's child). The tax is generally effective for generation-skipping transfers made after June 11, 1976. A transition rule allowed generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, and not amended after that date, to be tax free if the grantor or testator died before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

II. FRAMEWORK FOR DISCUSSION

On April 29, 1983, the Treasury Department submitted a proposal for a new generation-skipping transfer tax to replace existing Chapter 13. The Treasury proposal would completely exclude from the tax \$1 million per transferor (\$2 million for a married couple) and would subject generation-skipping transfers above this amount to tax at a flat rate (80 percent of the highest estate tax rate). The proposal would also extend the tax to direct generation-skipping transfers (to the extent they exceed the exempt amount).

The American Law Institute (ALI) recently completed a Study on Generation-Skipping Transfers under the Federal Estate Tax which also reviewed skipping transfers other than those skipping a generation. In addition to the Treasury proposal and the ALI recommendations, several bills have been introduced to repeal the generation-skipping transfer tax.

The hearing will focus on Treasury's alternative generation-skipping transfer tax, the ALI study project report, and additional simplification proposals to the existing generation-skipping transfer tax. In announcing the hearing, Chairman Rostenkowski stated, "These hearings are being announced far in advance of the scheduled date so that the many interested individuals and groups will have adequate time to study the numerous proposals to revise the generation-skipping transfer tax and to prepare detailed comments. The enactment of the generation-skipping transfer tax in 1976 was a result of a hard and long struggle to improve the fundamental equity of the Federal transfer tax system. I am very concerned with current proposals which would undermine or undo the essential fairness achieved in 1976 by simply discarding the generation-skipping transfer tax. However, I am equally concerned with the complexity of the existing generation-skipping tax structure. It is my hope that this hearing will afford interested parties the opportunity to present simplifying revisions and constructive alternatives to the present generation-skipping tax, but in a manner consistent with the essential tax policy goals achieved in the Tax Reform Act of 1976."

Details for submission of requests to be heard

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard in writing no later than close of business, Wednesday, September 5, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard must contain the following information:

One, the name, full address, and capacity in which the witness will appear, as well as a telephone number where the witness or a designated representative may be reached;

Two, a list of any clients or persons, or any organization for whom the witness appears; and

Three, topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the printed record of the hearing.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, September 21, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

[Press release No. 24—revised, Tuesday Aug. 7, 1984]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES POSTPONEMENT OF THE HEARING ON THE GENERATION-SKIPPING TRANSFER TAX

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, announced today that the public hearing scheduled for Tuesday, September 13, 1984, on the generation-skipping transfer tax, will be rescheduled for Tuesday, October 2, 1984, beginning at 10 a.m. in the Com-

mittee's main hearing room, 1100 Longworth House Office Building. The hearing is being postponed in order to allow time for legislation simplifying the transfer tax to be introduced and studied by interested parties. All other hearing details remain the same, with the exception of an extension of time for submission of written comments for the record as indicated below.

Chairman Rostenkowski announced his intention to introduce (by request) legislation which would implement the Treasury Department's generation-skipping transfer tax simplification proposal, as released on April 29, 1983 (including technical modifications included in later Treasury legislative drafts), and skipping transfer proposals developed by the American Law Institute as well as any other simplification proposals developed in a timely manner. It is anticipated that the legislation will be introduced no later than September 18, 1984, in order to give interested parties two weeks to review the bills before the hearing date. No final action on the proposals is contemplated by the Committee on Ways and Means this year. However, the Chairman expressed hope that the work done this year on this matter can lead to an expeditious resolution of the issue of simplification of generation-skipping transfer taxation early in the next Congress.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, October 12, 1984, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the committee office before the hearing begins.

Mr. GIBBONS. Good morning, ladies and gentlemen. Today the committee will hear testimony on proposals to simplify the generation-skipping transfer tax. Many have argued that the present GST tax, enacted in 1976, is too complex.

In order to facilitate today's discussions, Congressman Barber Conable and Chairman Rostenkowski recently introduced H.R. 6260 and H.R. 6261 which represent two major simplification proposals that have been presented to this committee. H.R. 6260 represents the Treasury Department recommendations, and H.R. 6261 represents the discussion draft of the American Law Institute.

I wish to emphasize that Chairman Rostenkowski's introduction of these two proposals should not be interpreted as a personal endorsement of either proposal—or the specific tax rates, exemption levels or credit amounts contained in these bills. These important policy issues will be considered and decided by this committee next year.

In addition, the two bills do not contain an effective date. I hope that testimony presented today will focus upon the more substantive issues at hand rather than when these changes might become effective. I want to reiterate, however, Chairman Rostenkowski's comments on introduction of the bills.

I would like to emphasize here that anybody who does that at his/her own risk may have to bear the responsibility of it, because I doubt we are going to create any great big window period. I would like to emphasize that the enactment of a generation-skipping transfer tax in 1976 was the result of a long and hard struggle to improve the fundamental equity of the Federal transfer tax system. I am very concerned with current proposals which would undermine or undo the essential fairness achieved in 1976 by simply discarding the GST tax.

It is my hope that today's hearing will afford interested parties the opportunity to present simplifying revisions and constructive alternatives to the present GST tax, but in a manner consistent with the essential tax policy goals achieved in the Tax Reform Act of 1976.

The committee has made an effort today to hear everyone who has requested to testify. Consequently, today's hearings may be long. I hope the witnesses will summarize their statements. The full statement of each witness will be made a part of the hearing record.

Congressman Conable may wish to make a statement when he is able to attend. I must point out to all attending today that this could be a very foreshortened session. The current chairman has to be at two meetings before 1 o'clock and one at 11. And Chairman Rostenkowski is on the House floor now handling a piece of legislation from this bill.

If we have inconvenienced you, we apologize, but such is the problem that occurs as the Congress comes to an end.

Our first witness this morning is the Acting Assistant Secretary for Tax Policy, the Honorable Ronald A. Pearlman, U.S. Department of the Treasury. Mr. Pearlman.

STATEMENT OF HON. RONALD A. PEARLMAN, ACTING ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Thank you, Mr. Chairman. I appreciate being here, Mr. Chairman, for the purpose of trying to give the committee some comments from the Treasury Department on the generation-skipping transfer tax concept in general and in particular on Treasury's suggestion regarding the implementation of a simpler, fairer tax.

Hopefully, Mr. Chairman, this hearing is the beginning of a process which finally will resolve the disagreements about the proper form of a generation-skipping transfer tax by the Congress. Hopefully, we will see in 1985 the enactment of a simpler and fairer tax for the efforts that have been put forward in putting these bills in statutory form and for introducing them. We express our appreciation and compliments to Chairman Rostenkowski and Mr. Conable and to the staff of the committee.

I think this is the best in the legislative process. It is an opportunity for people to look at the statutory language and have comment. And hopefully this process will produce the kind of tax legislation which we all can be satisfied with.

Let me emphasize the importance the Treasury attaches to the generation-skipping transfer tax as part of an equitable and comprehensive transfer tax system. There are basic reasons for a generation-skipping transfer tax. First, it clearly prevents the erosion of the estate tax base.

Second, it eliminates unfairness in a system in which the wealthiest of our citizens can avoid tax, while individuals having more modest means, but who nevertheless have taxable estates, cannot. This unfairness affects the progressivity of the transfer tax system and encourages taxpayers to establish trusts versus out-

right transfers in situations where, in our judgment, the tax system should be neutral in their making their decisions.

So we believe in a generation-skipping transfer tax because it protects the transfer tax base and promotes fairness and neutrality. That does not mean, Mr. Chairman, that we are insensitive to the criticisms that have been lodged against the current tax enacted in 1976. Frankly, we think many of the criticisms are overstated, but we have spent a substantial amount of time in trying to understand those criticisms and develop ways to effectively respond to them.

For our purposes, there are three problems, three main problems with the 1976 act. One is complexity. Second is the breadth; that is, that simply too many taxpayers are covered by that legislation. Generation-skipping transfers are essentially a problem limited to the very wealthy of our society and we think the tax can be properly targeted to that group of taxpayers.

Finally, the so-called layering technique whereby under the 1976 act there are ways that can effectively permit taxpayers to effectively avoid the thrust of the GST. To respond to these criticisms we have offered a proposed substitute GST which the chairman and Mr. Conable were good enough to introduce for consideration. It adopts three policy conclusions.

The first, a large exemption to eliminate the vast majority of taxpayers from the GST system; second, a flat rate designed to reduce the complexity of the tax and ease the administrability of the tax; and third, to apply the tax at each generation level in order to make it effective and fair and as neutral as possible.

I would like to emphasize that the notion that a transfer tax should be imposed once per generation was not the starting point for Treasury's analysis. Indeed, it was the conclusion we reached by applying the general principles to the particular problems involved in generation-skipping transfers.

Clearly this is the most important but also the most controversial aspect of the Treasury's proposal. For that reason I would like to turn to the reasons for reaching this conclusion.

If a GST tax is to be imposed at all it seems clear to us that it should be applied to a situation where a grandparent sets up a trust for the benefit of his child and grandchildren, giving the child an interest in the income in corpus during his lifetime, then the power to say where that property is to be transferred at the child's death.

If such a tax is not imposed in that situation, the transfer tax system discriminates heavily against outright transfers to children and in favor of such multigenerational trust arrangements, since in the latter case it is possible to avoid the estate tax otherwise payable at the death of the child. Indeed, recognition of this fact led to enactment of the GST in 1976.

The question of whether a tax should be imposed at the child's level becomes harder to answer, though, if the child is given a smaller bundle of rights with respect to the trust property. What if the child is given a life income interest, but no power over the trust property at death? What if the child has no right to receive the trust property himself, but is given complete right to determine

who does in fact receive the property both during lifetime and death?

Does it matter whether the child's power is held as a trustee? What if the child has no absolute right to receive trust income and no power to direct disposition of the trust corpus?

The current GST tax answers these questions by providing that any interest in the trust property held by the child, no matter how small, will trigger imposition of the tax, but that powers over the disposition of the trust property will be ignored as long as the power is limited to a power to appoint among lineal descendants.

This system eliminates the disparity between giving the child outright ownership of the property and making him one of several beneficiaries of flexible trust. However, the system is far from neutral. It merely substitutes one disparity for another. If the transferor is willing to withhold from his child the right to receive property from the trust during his lifetime, but gives the child full control over the disposition of the property to the child's children, grandchildren, siblings, nieces or nephews, no tax is imposed at the child's death.

On the other hand, if the child is given merely a contingent right to receive trust corpus, the entire trust is taxed at his death even if the child never receives a cent from the trust. If the child is of relatively modest wealth, the decision whether to give a child an interest in a trust may be a difficult one.

In the event of an emergency or significant change in economic circumstances, the child may need or want to have access to the trust. On the other hand, the child may never need the trust property. The current GST tax says in effect that if flexibility is retained the tax will be imposed. If flexibility is forgone, the tax can be avoided. Ironically, by imposing the tax on this basis, the 1976 statute replaces the bias that the estate tax creates in favor of flexible trusts, with a strong prejudice against such arrangements.

Moreover, the current system is inequitable in that the wealthiest taxpayers are the best able to avoid the tax. We include, Mr. Chairman, in our statement, an example of a couple of family situations. One in which a parent with rather substantial assets but not what you would call super wealthy taxpayers, assets in this case of \$3 million, and has a child and several grandchildren. The child is a successful professional with a net worth of several hundred thousand dollars. The grandchildren are minors. This is a typical situation.

In planning that estate, the taxpayer would probably be reluctant to leave any substantial portion of his wealth in trust where the child was given no interest in the property. That is, that the level of assets of the child were simply not large enough to give confidence to the parent that some day in the future, for health needs or other needs, the child may not need those assets. So that typically in that kind of situation, absent tax considerations, the parent would likely want to leave most of his wealth outright to his child or into some kind of flexible trust for the benefit of the child and grandchildren.

Even though the current tax system tells him that if he transfers property directly to his grandchildren he avoids a tax in his child's estate, he probably will continue to be reluctant to transfer more

than a fairly smaller percentage of his wealth directly to the grandchildren. Now, flip the example and talk in terms of a parent with \$30 million assets rather than \$3 million and a child with substantial assets, say a millionaire in his own rights. That is a situation in which the parent can have reasonable confidence the child can function on his or her own without leaving a substantial block of assets directly to that child.

In that case, the wealthier taxpayer, without taking tax considerations into his plan, might have plans similar to his less wealthy counterpart. But here, he might respond differently. For example, because of the generation-skipping transfer tax which imposes a tax on anything left to his child, he might break his \$30 million estate into two pieces and leave a piece of it—\$5 million we have posited in our statement—to his child, which certainly would give the child adequate protection, and leave the remaining \$25 million in a trust for the grandchildren in which the child is not given any present income interest but only a right to determine ultimately how and when the children, grandchildren are to receive those interests.

Thus, while it is likely that a second transfer tax in the child's generation will apply to a portion of that estate, \$5 million in my example, such a system permits a very substantial portion of that parent's assets to escape a tax and skip a generation.

That system, in our judgment, presents unfairness and, as applied to the wealthiest taxpayers, frankly is largely ineffective. What then is the solution? The lack of neutrality and unfairness cannot be cured by treating any power over property as a taxable ownership interest. This simply moves the disparity to another place in the system.

Congress tried this approach once in 1942 with disastrous results, by enacting power of appointment rules intending to achieve this effect and not too long after—in the early 1950's—had to go back and rescind retroactively those rules.

So after considering that history and considering the issue in the present context, we have concluded that the only way to impose a generation-skipping transfer tax that is an effective backstop to the estate gift tax system, but that also results in a fair and neutral system, is to impose a tax at each generation regardless of whether a member of that generation has an interest in or power over that property.

If a generation-skipping transfer is imposed on transfers from a grandparent directly to a grandchild, a so-called direct skip, property passing from the grandparent to the grandchild will always be subject to tax.

This makes the system neutral because taxpayers with accumulations of wealth are free to let nontax considerations determine how they pass their wealth down to their families. That is, if they want to use trusts, they can use trusts. If they want to pass assets directly to grandchildren they can do that. And the tax system will not affect that judgment.

It makes the system fair because the wealthiest families will pay tax on the same basis as families of more modest wealth. And the tax is effective since no amount of clever planning can avoid imposition of a second tax in the child's generation.

Before leaving this subject, I would like to respond to two arguments frequently made against imposition of a GST tax on a transfer directly from a grandparent to a grandchild. First, it is frequently argued that if the property is transferred in a direct skip from grandparent to grandchild, there is only one transfer. So there should only be one tax. This argument has an intuitive appeal perhaps, but misses the essential point. And that is that imposition of a GST tax on direct skips is necessary for the transfer tax system to work properly.

Again, the gift tax provides a useful analogy. Before 1932, people were accustomed to thinking of the estate tax as a tax that applied only at death. This view had to be expanded because people simply used lifetime transfers as a vehicle for avoiding the estate tax.

Similarly, it is necessary here to expand our thinking about the proper structure of the transfer tax system to prevent taxpayers from avoiding such a tax in their children's generation. It is no more persuasive to argue today that one transfer implies one tax than it would have been to argue in 1932 that a lifetime transfer should not be subject to a transfer tax because it does not involve a transfer by a decedent.

Second, it is sometimes argued that a tax on the direct skip from a grandparent to grandchild unfairly penalizes such transfers when compared with transfers to children. In fact, the transfer on direct skips is not a penalty at all. It merely neutralizes the tax advantage that otherwise would attach. In other words, without a tax on direct skips a transfer to a child followed by a retransfer to the grandchild is penalized since the property received will have been subject to two transfer taxes by the time the grandchild receives the property.

The property transferred directly to grandchildren will be subject to only one transfer tax unless a GST tax is imposed on direct skips. Now, we recognize that there are situations in which legitimate nontax reasons for wishing to make direct transfers to grandchildren will prevail. Moreover when relatively small amounts are involved, transfer taxes are often an insignificant consideration. In part for this reason, our proposed GST tax would not apply to cumulative transfers up to \$1 million and that should take care of those situations.

Now, I would like to turn much more briefly, Mr. Chairman, to issues considerably less complicated and controversial than whether to impose a transfer tax on direct skips.

First, I would like to very briefly address the question of when should the generation-skipping transfer tax be imposed. We concluded that imposition should be at the point in time when the fact and the amount of the generation-skipping become certain.

For example, a trust is set up for a child and grandchild. There is discretion in the trustee as to whom the income in the corpus is to be applied. It can be determined that there is a generation-skipping transfer only when the child dies or when the child's interest in that trust otherwise terminates. We think that that is the appropriate point in time to impose the generation-skipping transfer tax.

Or for example, when there is an outright transfer of assets to a grandchild or transfer to a grandchild in trust, without any interest in the child, it is clear at that point in time that there has been

a generation-skipping transfer, and we think that is the appropriate point in time to impose the generation-skipping transfer tax.

At first, it might appear that this rule results in a more harsh treatment on direct skips than taxable distributions and taxable terminations of trusts. In fact, we do not think this is the case. It has long been recognized that an early payment of a transfer tax carries with it a detriment and an offsetting benefit. The detriment is obvious.

The taxpayer must pay his tax sooner so he loses the benefit of the use of that money, but there is an offsetting benefit that is a very significant one. That is that the transfer tax base, the value of the property at the time of the earlier payment, is taxed. Any post-transfer appreciation in that value escapes tax. So while there is a detriment in terms of an early tax, there is a very significant benefit to the extent there is appreciation in that property subsequent to tax.

Without this balancing of an earlier payment of tax against the benefit the taxpayers receive, if there is a post-transfer appreciation, a unified estate gift tax using the same rate schedule would discriminate heavily against lifetime gifts. Were it not for the possibility of excluding future appreciation from the transfer tax base, no taxpayer would ever make a lifetime taxable gift unless he were given a substantial discount on his gift tax payment. Conversely, the recently enacted unlimited marital deductions would be unthinkable from the Government's standpoint. The effect of an unlimited marital deduction on revenues would be intolerable were it not for the fact that the transfer tax base continues to grow during the lifetime of the surviving spouse.

The same principle is applicable to the timing of payment of the generation-skipping transfer tax. Accordingly, the fact that the tax paid up front while the tax on taxable distributions and taxable terminations from trusts is postponed does not mean direct skips are treated unfairly. Moreover, as we point out in our written statement, direct skips are treated even more favorably in one respect than generation-skipping transfers.

Second, after we determine the time of the tax, then we need to address the question of the rate of the tax. We made a basic policy decision. And that was we wanted a flat rate of tax because we believed that a flat rate of tax substantially simplified the 1976 law, current law. It simplified it both from the standpoint of taxpayers and their adviser's understanding and applying the principles of a GST, and from the standpoint of the Internal Revenue Service's administration of the GST tax.

In addition to that, I think it is noteworthy, at least, that we materially narrowed the estate tax spread of rates, from now currently from a low rate of 37 percent to a high rate of 50 percent. The level of progressivity in the current estate tax has been narrowed significantly.

So in selecting a flat tax you don't disturb that progressivity very dramatically. Now we have suggested a rate of 80 percent of the top Federal estate tax rate. Under current law, where the rate is 55 percent, that would produce a generation-skipping transfer tax rate that would apply to all taxable generation-skipping transfers of 44 percent.

Now, that was a compromise. On the one hand one can argue that the highest rate applicable in the estate tax system currently 55 percent, should apply to generation-skipping transfers by the wealthiest of individuals who, if they didn't make transfers by generation-skipping, but simply went thorough the normal estate tax system, would be subject to a 55-percent rate.

On the other hand, it is clear that, even applying the \$1 million exemption that we propose, that there will be some taxpayers who will not be in the highest estate tax rate, and therefore, it would not be fair to them to apply the highest estate tax rate. So what we chose to do was pick a middle ground. And the middle ground we picked was 80 percent of the highest rate or, as I indicated, under currently law 44 percent.

Now, let me say that when you select rates as we did, and we select exemptions as we did, you make compromises. The thing I would like to emphasize is the interrelationship of those compromises. We selected an 80 percent of the maximum rate on the assumption that the exemption from tax, the across-the-board exemption, would be \$1 million. We recognize that there are strong views among certain sectors to increase that exemption level.

Indeed, some view that that exemption level should be increased dramatically. We do not share that view. We think it would be unfortunate if that were to happen. But let me emphasize that if that were to happen, if the committee were to decide to increase that exemption level, then we think that it would be a serious mistake to continue to apply a flat rate of 80 percent of the maximum rate.

And if the exemption level were increased over the \$1 million that we have recommended, then we would urge the committee to seriously consider making the flat rate—if the committee adopts our recommendation of a flat rate—the maximum Federal estate tax rate.

The next feature of the Treasury's proposal concerns the calculation of the tax base upon which the flat rate of tax is imposed. This issue arises because the estate and gift tax do not calculate the tax base in a consistent manner. Now, I am not going into the reasons for that. It is dealt with in our written statement. In order to save some time, I am going to eliminate that.

Let me just say that in the classic generation-skipping trust where a child of a grantor is given an interest in the trust property during his entire lifetime, it seems to us that the tax being avoided is the estate tax. And therefore, under the current generation-skipping transfer tax and under the Treasury proposal, the tax on taxable terminations when that asset comes out of trust should be imposed on what is referred to as a tax inclusive basis.

If the tax on terminations were imposed on a so-called tax exclusive basis, and as I said, we go into the details of that more in our written statement, the effective tax rate would be reduced very significantly. And I want to emphasize that.

The rate goes down dramatically. And substantial incentives would remain in the system for people in the top brackets to continue to use generation-skipping trusts. So we have a very strong bias in favor of using a tax inclusive system. And as you hear testimony today and as the committee considers this issue, I think that people have to recognize the impact it has on the effective rate of

tax if we depart from a tax-inclusive system and move to a tax-exclusive system.

The third major feature of the Treasury's tax proposal is to give each individual \$1 million exemption, as I mentioned to you. Now, the clear benefit of that approach is to exclude the vast majority of taxpayers from the generation-skipping transfer tax system. And that was our intention. That was why we chose the exemption level that we did.

To give you some facts that might be instructive, the individual transfers during life and at death total no more than \$1 million, he can ignore the generation skipping transfer tax in planning his estate. It will never apply to any transfer made by that individual nor to any trust created by that individual.

We chose \$1 million, as I mentioned to you, as a compromise. We obviously did not want to set the level too low and then find we brought too many people back into the system. On the other hand, we did not want to set the level too high and exclude the wealthiest of taxpayers from that system. We think \$1 million produces a sensible level of exclusion.

Let me give you some numbers. We estimated that there will be 2 million decedents projected to die in 1988. Only 9,000 of them will have gross estates in excess of \$1.25 million. This represents 35 percent of the 25,800 decedents who will have estates large enough to be subject to the estate tax and only .45 percent, less than 1 percent, of all decedents dying in 1988.

Of course the number of decedents having taxable estates in excess of \$1.25 million will be far smaller in light of the extensive use of the charitable and unlimited marital deduction. So, in fact, our numbers probably will be even less than I have suggested.

In our written statement we have included a table which shows what happens when you increase the exemption level. What it shows is, even if you increase it slightly, you dramatically reduce the number of taxpayers who we would categorize as the wealthiest taxpayers in our society who are subject to tax. So we would suggest to the committee that it not deviate significantly from the \$1 million exemption level and encourage the committee to address the issue of what are we doing to the transfer tax system if we depart dramatically.

As I indicated, if the committee chooses to depart from the \$1 million exemption, we believe serious consideration should be given to a flat rate imposed at 100 percent of the top estate rate other than the 80-percent tax rate we have suggested in our proposal.

There are several other items we cover in our written statement that I will exclude from my oral comments. But I would like to conclude, Mr. Chairman, by just making a very general comment about the ALI discussion draft. I started by saying, I think, that Chairman Rostenkowski and Mr. Conable have made a significant contribution to the process by encouraging staff to draft both proposals and to put those proposals forward for consideration by the committee and by the public at large.

There are differences, obviously, between the Treasury Department proposal and the ALI discussion draft. Those differences as to exemption versus credit, for example, timing of the tax, rate of the tax, basis for imposing the tax; that is, whether it should be im-

posed on a tax exclusive versus tax inclusive basis, other issues which we have noted in our written statement, are the things that will receive the attention. And obviously they should.

I would like to emphasize, however, that in the overall structure and in the general philosophy of the two proposals, the similarities clearly outweigh the differences. Both proposals abandon the notion of a tax and exemption level based on the specific tax profile of the transferor in favor of a flat rate of tax, and an independent mechanism for removing small transfers from the system, things that we believe are very important in trying to simplify the system.

Both proposals would apply a tax to distributions out of current trust income, unlike the current generation-skipping transfer tax, which we believe is extremely important in giving integrity to the tax.

Finally, both proposals embody the conclusion that a tax must be imposed on direct skips—that is, outright skips, as referred to in the ALI proposal—in order to prevent avoidance of the tax on distributions and terminations from trusts. So we think that the process of melding the ALI and Treasury proposals is one that is not insuperable and we think is very achievable.

I would like to conclude, Mr. Chairman, again thanking Chairman Rostenkowski for calling this hearing, for encouraging the committee to take action on this issue. In 2 short years, the generation-skipping transfer tax will be 10 years old. There is no reason why the effort of this committee cannot be a serious beginning point for dealing with this issue in 1985. We hope that we will continue to be helpful in that process.

Obviously, as is hopefully always the case, we are available to give whatever assistance the committee and members of the committee staff think will be helpful in enabling the committee to fashion a simple and a fair and an effective tax that we think will make the transfer tax system work.

That concludes my prepared statement, Mr. Chairman. I would be happy to try to answer your questions.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, ACTING ASSISTANT SECRETARY, TAX POLICY,
DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the committee, I am pleased to have this opportunity to present the views of the Treasury Department regarding the generation-skipping transfer tax. I would like to begin by thanking the Chairman for calling this hearing and for introducing a bill (H.R. 6260) embodying the Treasury Department's 1983 Proposal to Simplify and Improve the Generation-Skipping Transfer Tax. I share the Chairman's hope that this hearing will be the beginning of a process that, with the cooperation of all interested parties, will lead to the resolution of the long-standing, difficult problem of finding a workable replacement to the current generation-skipping transfer tax.

WHY A GENERATION-SKIPPING TRANSFER TAX IS ESSENTIAL

Perhaps the best way to appreciate the need for a generation-skipping transfer ("GST") tax is by analogy to the gift tax. Just as a gift tax is essential to prevent an individual from avoiding the estate tax in his own generation, a GST tax is necessary to prevent an individual from transferring wealth to his descendants in a form that avoids the estate or gift tax in succeeding generations. To see that this is so, one need only to look to the fact that long-term, multi-generational trusts are so prevalent in the estate plans of wealthy individuals. Had Congress recognized and

acted upon the generation-skipping problem at the time the gift tax was enacted, this would not be possible. While we are not suggesting that Congress should attempt to impose a tax on existing generation-skipping arrangements, we believe it is essential that Congress prevent this erosion of the federal transfer tax base for future generations.

Perhaps a more significant reason for imposing a tax on generation-skipping transfers is that a transfer tax system without such a tax is fundamentally unfair. This stems from the fact that the wealthiest individuals are in the best position to engage in generation-skipping transfers while those of more modest wealth may be reluctant to enter into such arrangements.

This has two effects. First, it greatly undermines the progressivity of the federal transfer tax system. If families of modest wealth are paying a transfer tax in every generation while the wealthiest families are paying tax every other generation (or less frequently), the progressivity of the system is turned upside-down. Second, an estate tax without a GST tax has the perverse effect of taxing wealth that an individual has accumulated during his own lifetime more harshly than wealth that has been inherited. Newly accumulated wealth generally cannot be passed to lower generations without the payment of an estate or gift tax. On the other hand, inherited wealth is often received in a form that allows it to escape estate tax at the death of the recipient. Treasury believes that the form in which property is transmitted from generation to generation should not affect the transfer tax burden on that property and that inherited wealth should not be taxed more favorably than assets than an individual accumulates during his own lifetime.

The final reason for supplementing the federal estate and gift tax with a GST tax is that, without such a supplement, the transfer tax system is not neutral, that is, it biases taxpayers' decisions about how to transfer their property during lifetime and at death. Without a GST tax, the estate tax encourages those taxpayers who might otherwise be inclined to leave property outright to their children to create trusts for the benefit of their children and lower generations. While there are many legitimate, nontax reasons for using flexible trusts, the tax system should not encourage people to enter into such arrangements purely for tax reasons.

TREASURY'S 1983 PROPOSAL

Bearing in mind the principles of fairness, neutrality, and protection of the transfer tax base, Treasury set out to design a new tax on generation-skipping transfers. Of course, we were not writing on a clean slate; Congress adopted such a tax as part of the Tax Reform Act of 1976 and this tax is still in effect.

Since its enactment, the present GST tax has been the subject of a good deal of criticism. While Treasury believes that many of the criticisms of the existing generation-skipping transfer tax have been greatly overstated, we have concluded that the 1976 statute does present a number of real problems.

Chief among these problems is the complexity of the current GST tax. It would appear that, in a well-meaning attempt to design a system that achieves perfect neutrality between generation-skipping transfers and transfers that do not skip generations, Congress enacted a tax system that is too difficult for many practitioners to understand and, in certain respects, too complex for Treasury and the IRS to administer.

Second, the current GST tax has an impact upon too many taxpayers. As mentioned above, the generation-skipping problem is largely confined to wealthy taxpayers. The current GST tax is not so limited. As a result, even individuals with relatively modest accumulations of wealth need to take into account the current GST tax in planning their estates.

Finally, even if the tax could be enforced and administered as intended by Congress in 1976, it would not cure the generation-skipping problem. Soon after enactment of the tax, it was observed that the wealthiest transferors can largely avoid the impact of the tax by "layering" their estates, that is, by setting up separate trusts for children and grandchildren. Since the 1976 tax applies only to trusts that have beneficiaries in more than one generation, the layering technique effectively avoids the tax on the assets passing directly to the grandchildren. Moreover, even for transferors who do not layer their estates, the tax can be avoided through the use of three major exceptions built into the 1976 statute: (1) the \$250,000 exemption for transfers to grandchildren; (2) the rule that a power to appoint property among the lineal decedents of the grantor does not cause the holder of such a power to be treated as a beneficiary of a trust; and (3) the complete exemption from the GST tax of distributions out of current trust income.

Putting together the experience under the 1976 statute with the general principles set forth above, we have reached three major conclusions:

1. A large exemption is necessary to eliminate the vast majority of taxpayers from the GST tax system. Such an exemption would mean that, as a practical matter, most taxpayers and most tax practitioners could plan their affairs without regard to the GST tax. Also, from an administrative standpoint, a tax affecting a relatively small number of taxpayers would be more manageable. On the other hand, the exemption level should not be set higher than necessary to accomplish these goals.

2. The tax should be applied at a flat rate. This change would make the tax easier to understand and apply for those taxpayers remaining within the system and would ease further the problems of administering the system.

3. Finally, a transfer tax must be imposed at each generation level in order for the tax to be effective, fair and neutral.

At the outset, I would like to emphasize that the notion that a transfer tax should be imposed once per generation was not the starting point for Treasury's analysis; it was the conclusion that we reached by applying the general principles noted above to the problem at hand. Since this is clearly the most important and controversial aspect of Treasury's proposal, I would like to turn immediately to the reasons for reaching this conclusion.

A TAX ON DIRECT GENERATION-SKIPPING TRANSFERS

If a GST tax is to be imposed at all, it seems fairly clear that it should apply to a situation where a grandparent sets up a trust for the benefit of his child and his grandchildren, giving the child an interest in the income and corpus of the trust during his lifetime and the power to say where the property is transferred at his death. As noted above, if such a tax is not imposed, the transfer tax system discriminates heavily against outright transfers to children and in favor of such multi-generational trust arrangements since, in the latter case, it is possible to avoid the estate tax payable at the death of the child.

Recognition of this fact led to the enactment in 1976 of the current tax on generation-skipping transfers. The 1976 statute treats the child, in effect, as if he had been the owner of the property and had transferred it to his grandchildren.

The question of whether a tax should be imposed at the child's level becomes harder to answer, though, if the child is given a smaller bundle of rights with respect to the trust property. What if the child is given a life income interest but no power over the trust property at his death? What if the child has no right to receive trust property himself but is given complete discretionary power to say who receives the trust property during his lifetime and at his death? Does it matter whether the child's power is held as a trustee? What if the child has no absolute right to receive trust income and no power to direct the disposition of trust property but is a permissible recipient of distributions from the trust if needed for his health, education, support or maintenance?

The current GST tax answers these questions by providing that any interest in the trust property held by the child (no matter how small) will trigger imposition of the tax but that powers over the disposition of trust property will be ignored as long as the power is limited to the power to appoint among lineal descendants of the grantor. This system eliminates the disparity between giving the child outright ownership of the property and making him one of several beneficiaries of a flexible trust. However, the system is far from neutral; it merely substitutes one disparity for another. If the transferor is willing to withhold from his child the right to receive property from the trust during his lifetime but gives the child full control over disposition of property to the child's children, grandchildren siblings, nephews and nieces (clearly an important attribute of ownership), no tax is imposed at the child's death. On the other hand, if the child is given merely a contingent right to receive trust corpus, the entire trust is taxed at his death, even if the child never receives a cent from the trust.

If the child is of a relatively modest wealth, the decision whether to give a child an interest in a trust may be a difficult one. In the event of an emergency or a sharp change in economic circumstances, the child may need or want to have access to the trust. On the other hand, the child may never need the trust property. The current GST tax says in effect that if flexibility is retained, a tax will be imposed; if flexibility is forgone, the tax can be avoided. Ironically, by imposing the GST tax on this basis, the 1976 statute replaces the bias that the estate tax creates in favor of flexible trusts with a strong prejudice against such arrangements.

Moreover, the current system is inequitable in that the wealthiest taxpayers are best able to avoid the tax. Consider, for example, a taxpayer with one child and

three grandchildren and with assets of \$3,000,000. The child is a successful professional with a net worth of several hundred thousand dollars. The grandchildren are still minors. In planning his estate, this taxpayer would probably be reluctant to leave any substantial portion of his wealth in a trust where the child was given no interest in the property. Absent tax considerations, the taxpayer would most likely want to leave most of his wealth outright to his child or in a flexible trust for the benefit of the child and the three grandchildren. Even though the current tax system tells him that if he transfers property directly to his grandchildren, he avoids a tax in his child's estate, he probably would continue to be reluctant to transfer more than 10-20 percent of his wealth directly to grandchildren.

Now change the example so that the grandparent has a net worth of \$30,000,000 and the child is a millionaire in his own right. (The family structure is the same.) Absent tax considerations, this wealthier taxpayer might have plans similar to those of his less wealthy counterpart for disposition of his wealth at his death. However, the wealthier taxpayer is likely to respond quite differently to a GST tax imposed on any property in which his child has an interest. For example, this transferor might well divide his wealth into two trusts: (1) a \$5,000,000 trust in which the child is given an income interest and limited rights to receive trust principal (with remainder to the grandchildren) and a \$25,000,000 trust in which the child has no interest but over which the child is given a complete discretionary power to determine the timing and amounts of distributions to the grandchildren. Thus, while it is likely that a second transfer tax in the child's generation will apply to 80 to 90 percent of the \$3,000,000 accumulation of wealth, as little as 10 to 20 percent of the \$30,000,000 accumulation will be subject to this second tax. A system that allows such a result is simply unfair and, as applied to the wealthiest taxpayers, largely ineffective.

What then is the solution? The lack of neutrality and unfairness cannot be cured by treating any power of appointment over property as a taxable ownership interest. This simply moves the disparity to yet another place. Congress tried this approach once in 1942, with disastrous results. Under the 1942 law, property was included in the estate of anyone having a power of appointment over the property (with certain exceptions). Rather than collecting any additional tax, this approach merely forced taxpayers to dispose of their property in rigid and inflexible ways. Congress recognized this fact in 1951 and revised retroactively the tax treatment of powers of appointment, so that property subject to a power of appointment would be included in the holder's estate only if the holder had the right to appoint the property to himself, his estate, his creditors or the creditors of his estate (known as a "general" power of appointment).

After considerable study of this difficult problem, Treasury has concluded that the only way to impose a generation-skipping transfer tax that is an effective backstop to the estate and gift tax system and that results in fairness and neutrality is to impose a tax in each generation, regardless of whether a member of that generation has an interest in or power over such property.¹ If a generation-skipping transfer tax is imposed on transfers from a grandparent directly to a grandchild (a "direct skip" in the language of H.R. 6260), property passing from the grandparent to the grandchild will always be subject to two transfer taxes, whether property passes first outright to the child, through a flexible trust, or directly to the grandchild. Thus, the tax incentive for making direct skips disappears.

This makes the system neutral because taxpayers with accumulations of wealth are free to let nontax considerations determine how they pass their wealth down to their families. It makes the system fair because the wealthiest families will pay tax on the same basis as families of more modest wealth. And the tax is effective since no amount of clever planning can avoid the imposition of the second tax in the child's generation.

Before leaving this subject, I would like to respond to two arguments frequently made against the imposition of a GST tax on a transfer directly from a grandparent to a grandchild. First, it is argued that if the property is transferred in a direct skip from a grandparent to a grandchild, there is only one transfer so there should be only one tax. This argument has intuitive appeal but it misses an essential point—imposition of the GST tax on direct skips is necessary for the transfer tax system to work properly. Again, the gift tax provides a useful analogy. Before 1932, people were accustomed to thinking of the estate tax as a tax that applied only at death. This view had to be expanded to include lifetime transfers to prevent taxpayers

¹ It is important to note that the ALI Discussion Draft (H.R. 6261) is based on the same fundamental conclusion.

from avoiding the estate tax in their own generation. Similarly, it is necessary today to expand our thinking about the proper structure of the transfer tax to prevent taxpayers from avoiding such a tax in their children's generation. It is no more persuasive to argue today that one transfer implies one tax than it would have been to argue in 1932 that a lifetime transfer should not be subject to a transfer tax because it does not involve a transfer by a decedent.

Second, it is sometimes argued that a tax on a direct skip from a grandparent to a grandchild unfairly penalizes such transfers when compared to transfers to children. In fact, the tax on direct skips is not a penalty at all; it merely neutralizes the tax advantage that would otherwise attach to these transfers. In other words, without a tax on direct skips, a transfer to a child followed by a retransfer to the grandchild is penalized since the property received will have been subject to two transfer taxes by the time the grandchild receives the property. Property transferred directly to grandchildren will be subject to only one transfer tax unless a GST tax is imposed on direct skips.

We recognize, of course, that there are many legitimate, nontax reasons for wishing to make transfers to grandchildren instead of (or in addition to) transfers to children. Moreover, when relatively small amounts are involved, transfer taxes are often an insignificant consideration. In part for this reason, our proposed GST tax would not apply to cumulative transfers of up to \$1 million.

I turn now to issues considerably less complicated and controversial than whether to impose a tax on direct skips.

WHEN TO IMPOSE THE TAX

Having decided how many transfer taxes should be imposed, Treasury next faced the issue of when a tax should be imposed on a generation-skipping transfer. To answer this question, we adopted the basic principle that the tax should be imposed as soon as the fact and amount of the generation-skipping transfer becomes certain.²

If an individual creates a trust for the benefit of his children and grandchildren, neither the fact nor the amount of the generation-skipping transfer is known when the trust is created. At one extreme, all of the trust property may be distributed out to the children, resulting in no generation-skipping transfer whatsoever. At the other extreme, the children may receive no income or corpus from the trust, so that all the trust property passes to grandchildren and skips the children's generation. In many cases, the result will be somewhere in-between.

For any property held in a multi-generational, flexible trust, the fact and amount of a generation-skipping transfer does not become certain until the interests of all the children in that property terminates. This can happen either by an actual distribution of trust property to a grandchild (which is referred to as a "taxable distribution") or by a complete termination of all interests in the trust held by children (referred to as a "taxable termination"). As with the 1976 GST tax, the Treasury proposal imposes a tax upon taxable distributions and taxable terminations.

With respect to an outright transfer to a grandchild, the fact and amount of the generation-skipping transfer is certain at the time of the transfer. The same is true of a transfer to a trust exclusively for the benefit of one or more of the transferor's grandchildren.³ Thus, in both of these cases, the GST tax is imposed at the time of transfer under the Treasury proposal.

At first, it may seem that this rule results in a more harsh treatment of direct skips than taxable distributions and taxable terminations. In fact, this is not so. It has long been recognized that an early payment of a transfer tax carries with it a detriment and an offsetting benefit. The detriment is obvious: the taxpayer must part with his money (the investment income it would produce). The offsetting benefit is that the transfer tax base is the value of the property at the time of the earlier payment; any appreciation in value of the property subsequent to the transfer is not subject to tax. If the rate at which the property appreciates in value (or produces income) is equal to the rate of return the taxpayer could have received on the funds use to pay the transfer tax, and if the tax rate that would be applied at both times is the same, the detriment and benefit offset exactly.

² The ALI Discussion Drafts adopts a different principle—a tax is imposed when property is distributed or transferred to a beneficiary two or more generations below the transferor, but in no event later than the death of the last grandchild.

³ Under H.R. 6261, the tax is not imposed until actual distributions to grandchildren are made, or until the last grandchild dies.

Without this fundamental fact, a unified estate and gift tax using the same rate schedule would discriminate heavily against lifetime gifts. Were it not for the possibility of excluding future appreciation from his transfer tax base, no taxpayer would ever make a taxable lifetime gift unless he were given a substantial discount on his gift tax payment. Conversely, the recently enacted unlimited marital deduction would be unthinkable from the Government's standpoint. The effect of the unlimited marital deduction on Government revenues would be intolerable were it not for the fact that the transfer tax base continues to grow during the lifetime of the surviving spouse (to the extent it is not consumed).

This same principle is applicable to the timing of payment of the GST tax. Accordingly, the fact that a tax on a direct generation-skipping transfer is paid upfront while the tax on taxable distributions and taxable termination is postponed does not mean that direct skips are treated unfairly. Moreover, as will be seen below, direct skips are treated more favorably in one respect than other generation-skipping transfers.

RATE OF TAX

As noted above, a fundamental aspect of Treasury's 1983 proposal is that the generation-skipping transfer tax should be imposed at a flat rate.⁴ This decision was motivated primarily by a desire to achieve simplicity—a major problem with the 1976 GST tax is the difficulty of calculating a tax that is based on the tax profile of a "deemed transferor." (The difficulties result from identifying the deemed transferor and accounting for the fact that his tax profile changes over time.) Moreover, since the Economic Recovery Tax Act of 1981 significantly narrowed the range of effective estate tax rates (from 37 to 50 percent, eventually), a flat GST tax rate is justifiable.

Treasury has suggested that the GST tax rate be 80 percent on the top estate tax rate. This proposal represents a compromise between two competing considerations. On the one hand, the highest transfer tax rate should apply to generation-skipping transfers by the very wealthiest individuals to achieve the goals of neutrality and fairness. On the other hand, we recognize that, even with a \$1,000,000 exemption, some taxpayers would remain in the GST tax system who were not in the highest tax bracket. Moreover, since the GST tax is a substitute for the transfer tax in children's generation, we had to acknowledge that these children would not invariably be in the top bracket.

Recognizing that no single flat rate can achieve perfect fairness and neutrality for every family situation, we have proposed a flat rate equal to 80 percent of the top estate tax rate (currently producing a GST tax rate of 44 percent).⁵

Two points should be emphasized. First, this rate cannot be lowered without seriously compromising the effectiveness of the proposed GST tax as applied to the wealthiest taxpayers. Just as Congress recognized in 1976 that gift tax rates must be the same as estate tax rates in order for the gift tax to be effective, it must be recognized that if the GST tax rate is significantly lower than the top estate tax rate, the GST tax will not work properly.

Second, the choice of 80 percent of the top estate tax rate is clearly linked to the choice of a \$1,000,000 exemption. (The reason for this choice is discussed below.) If for any reason, Congress decides that a higher exemption level is necessary or appropriate, the justification for deviating from the top estate tax rate disappears.

BASIS FOR IMPOSITION OF THE TAX—"INCLUSIVE" VS. "EXCLUSIVE"

The next feature of the Treasury's proposal concerns the calculation of the tax base upon which the flat rate of tax is imposed. This issue arises because the estate and gift tax do not calculate the tax base in a consistent manner. The estate tax is imposed on the entire amount available for transfer; the amount that actually goes to pay the tax is not excluded from the base. To illustrate, if the estate tax were imposed at a flat rate of 50 percent, and if a decedent died with an estate of \$1,000,000, the tax would be \$500,000, leaving \$500,000 for the beneficiaries. Because the tax base includes the amount used to pay the tax, the estate tax is said to be imposed on a "tax inclusive" basis.

⁴ All ALI Discussion Draft reflects the same conclusion.

⁵ The ALI Discussion Draft proposes that the top estate tax rate be used. This is deceptive, however, since the tax under H.R. 6261 generally is imposed on a tax exclusive basis. See the discussion below.

By contrast, the gift tax is imposed only on the amount ultimately received by the donee. Thus, if the gift tax were imposed on this basis at a flat rate of 50 percent, a transfer of \$500,000 would attract a tax of only \$250,000. Looked at another way, the tax is only 33⅓% of the total amount (\$750,000) that is available to make the transfer and pay the tax thereon. Since the gift tax base does not include the amount used to pay the tax, the gift tax is said to be imposed on a "tax exclusive" basis.

Many have argued that there is no good reason for imposing the estate and gift tax on different bases, especially in light of the effort in 1976 to provide a fully unified estate and gift tax system. While this question is open to debate, the difference between the estate and gift tax is an undeniable feature of the present transfer tax system and one that makes the design of a neutral GST tax system considerably more difficult. More specifically, in designing a GST tax system to prevent the avoidance of a transfer tax in the generation below that of the transferor, one must ask whether the transfer tax being avoided is an estate tax or a gift tax.

In the case of a classic generation-skipping trust, where a child of the grantor is given an interest in the trust property during his entire lifetime, it would seem that the tax being avoided is an estate tax. Thus, under the current GST tax and the Treasury proposal, the tax on taxable terminations is imposed on a tax inclusive basis. If the tax on terminations were imposed on a tax exclusive basis, the effective rate of tax would be reduced significantly and substantial incentives would remain in the system for people in the top brackets to continue to use generation-skipping trusts.

At the other extreme, when a grandparent makes a direct skip to a grandchild, it seems more appropriate to say that a gift tax is being avoided since the grandparent could have transferred the property to the child who would make an immediate gift of the same property to the grandchild. Therefore, the Treasury proposal imposes the tax on direct skips on a tax exclusive basis. In reaching this conclusion, we took into account the fact that many taxpayers would not easily accept the notion that paying the tax on a direct skip up-front would carry with it an offsetting benefit of excluding subsequent appreciation from the tax base. Moreover, imposing the tax on direct skips on a tax exclusive basis serves to alleviate the hardship arising from having to pay two transfer taxes at the same time. In fact, the maximum marginal rate of tax applicable to a lifetime gift to a grandchild is only 55.2 percent when computed on a tax inclusive basis. This is insignificantly higher than the maximum rate of 55 percent that would apply to bequests to children.

The basis for taxing distributions from trusts is less clear. The current GST tax imposes the tax on distribution on a tax inclusive basis. This creates a highly desirable neutrality with respect to taxable terminations. On the other hand, it may be argued that distributions while a child is still alive are more like gifts by the child, so the tax should be imposed on a tax exclusive basis.

We have concluded that it is essential that taxable distributions be taxed on the same basis as taxable terminations. If this were not the case, then in a flexible trust for children and grandchildren, the grandchildren of the last child to die suffer a harsher GST tax than those of all other children. Moreover, to prevent avoidance of the tax inclusive tax on a taxable termination, it would be necessary to treat trust distributions within a short time before a taxable termination as if the distributions had not been made (similar to section 2035, involving gifts within 3 years of death). Hence, under the Treasury proposal, taxable distributions are taxed on a tax inclusive basis.⁶

A LARGE UP-FRONT EXEMPTION

The third major feature of Treasury's GST tax proposal is to give each individual a \$1,000,000 GST tax exemption. The clear advantage of this approach is that the vast majority of taxpayers, including all those with modest accumulations of wealth, are completely shielded from the impact of the GST tax system. This means that if an individual's transfers during lifetime and at death total no more than \$1,000,000, he can safely ignore the GST tax in planning his estate—it will never apply to any transfer made by that individual nor to any trust created by that individual.

⁶ The ALI Discussion Draft taxes outright skips and taxable distributions on a tax exclusive basis and taxable terminations on a tax inclusive basis. Unfairness to the beneficiaries of the last grandchild to die is avoided by treating any distribution within 9 months after a taxable termination as a taxable distribution. Thus, unless the trust continues beyond the death of the last grandchild, the GST tax under H.R. 6261 will always be imposed on a tax exclusive basis.

Treasury believes that an up-front exemption is a highly desirable feature of the GST tax for essentially two reasons. First, it limits the impact of the GST tax to that class of taxpayers where generation-skipping is most prevalent: wealthy individuals. Second, it removes the need for most tax practitioners and trustees to master and apply the GST tax. While we believe that Treasury's proposed new GST tax is considerably simpler than the current GST tax, it is obvious that certain complexities remain. This is inevitable; any GST tax that attempts to be reasonably fair and neutral will involve some complexity. We feel, however, that the remaining complexities are not unmanageable by those who will be advising the relatively few wealthy individuals who remain within the system.⁷

As to the size of the exemption, the choice of a \$1,000,000 figure again represents a compromise. The exemption level cannot be set too low—otherwise, too many taxpayers would remain within the system. Perhaps more significantly, given the decision to impose a flat rate of tax, a relatively low exemption level would argue for a lower flat rate of tax in order to avoid unfairness. A lower rate, however, would seriously dilute the effectiveness of the tax as applied to the wealthiest individuals.

On the other hand, the exemption level should not be set too high. Since our proposal involves free transferability of the exemption between spouses, a \$1,000,000 exemption per individual effectively becomes a \$2,000,000 exemption per married couple. Moreover, the exemption need not be applied to any portion of the combined taxable estate that is used to pay federal estate taxes. An estate of approximately \$1.25 million would pay approximately \$250,000 in estate tax after 1986, leaving \$1,000,000 of property which could be completely shielded from the GST tax. Thus, a combined estate of \$2.5 million would be free from the GST tax.⁸

We estimate that of the 2,000,000 decedents projected to die in 1988, only 9,000 will have gross estates in excess of \$1.25 million.⁹ This represents only 35 percent of those 25,800 decedents whose estates will be large enough to be subject to the federal estate tax and only 0.45 percent of all decedents dying in 1988. Of course, the number of decedents having taxable estates in excess of \$1.25 million will be far smaller in light of extensive use of the charitable deduction and the unlimited marital deduction.

The following table shows the impact on the above statistics of raising or lowering the \$1,000,000 exemption level:¹⁰

Exemption level	Maximum exempt gross estate	Number of decedents remaining in system	Percent of decedent remaining in system	Percent of all decedent
\$600,000	\$600,000	25,800	100	1.30
1,000,000	1,260,000	9,000	35	.45
1,250,000	1,705,000	5,300	21	.27
1,500,000	2,173,000	3,600	14	.18
1,750,000	2,666,000	2,700	10	.14
2,000,000	3,166,000	1,900	7	.10
2,250,000	3,666,000	1,500	6	.08
2,500,000	4,166,000	1,100	4	.06

This table shows that for each additional \$250,000 exemption, the maximum exempt estate increases by approximately \$500,000. Thus, the maximum exempt combined estate increases by \$1,000,000. (This assumes a top rate of 50%; the effect is even greater at a top rate of 55%.) The table also reveals the astounding fact that if the GST exemption level is raised to \$2.5 million, a couple with a combined taxable estate of over \$8.3 million will be able to shield their after-tax estate from the

⁷ The ALI Discussion Draft uses a credit mechanism rather than an exemption. Treasury acknowledges that a credit produces a more effective tax since transferors cannot place property in a trust that shields that property and all future appreciation from the GST tax. We feel, however, that the need to limit the scope of the GST tax justifies the use of an exemption.

⁸ This assumes the estate is split evenly between the two spouses. If this is not the case (for example, if the unlimited marital deduction is fully utilized), the maximum combined exempt estate would be even higher.

⁹ 1988 was chosen for this illustration since the unified credit will be fully phased in and the top rate will be lowered to 50 percent by that time.

¹⁰ This table represents a projection forward to 1988 of data gathered from 1982 estate tax filings. No attempt has been made to adjust for the probable effect of the changes made by ERTA (in particular, the unlimited marital deduction) on the size of gross estates.

GST tax. This would leave no more than a few hundred decedents subject to the GST tax each year (taking into account the charitable and marital deduction).

In light of the above considerations, we strongly urge the Committee not to deviate significantly from the \$1,000,000 exemption level.¹¹ If the Committee nevertheless decides to increase the amount of the exemption, we believe that serious consideration should be given to a flat tax imposed at 100 percent of the top estate tax rate.

TAX ON DISTRIBUTIONS OF TRUST INCOME

Under the current GST tax, distributions out of current trust income are completely exempt from tax. The primary justification for this exception apparently was that applying the tax to such distributions would be too complex.

While it cannot be denied that exempting distributions out of current trust income from the GST tax simplifies the system, it also creates a major loophole. Furthermore, it destroys the neutrality of the GST tax system.

If an individual transfers property outright to a child, and if the child regularly transfers all of the income from that property to his children (grandchildren of the original transferor), the child would be treated as making taxable gifts of the income to the grandchildren. If, on the other hand, the property is transferred to a trust, and if distributions out of the trust to the grandchildren are free from the GST tax, no transfer tax is ever paid on the value of the use of the property during the child's lifetime. In other words, the trust allows the child, in effect, to make tax-free gifts of the trust income to the grandchild during his lifetime, with no gift tax consequences until the child's death. This is the same type of abuse that the Supreme Court recently held to be impermissible in the *Dickman* decision.

Such a result clearly cannot be permitted if the GST tax is to be at all effective. Moreover, whatever the complexities would have been of taxing income distributions under the 1976 GST tax statute, these difficulties are considerably lessened under the Treasury proposal. From the standpoint of computation, the calculation is not at all difficult since the GST tax is imposed at a flat rate. Also, the mechanism for avoiding the imposition of an income tax and a transfer tax on the same amount is quite simple: the recipient of the distribution is given an income tax deduction for any GST tax attributable to the distribution.¹² Finally, from the standpoint of trust administration, the tax on income distributions should not be overly burdensome on trustees since relatively few trusts will be subject to the GST tax in light of the \$1,000,000 exemption.

EFFECTIVE DATES

The Treasury Department has proposed that the current GST tax be repealed retroactively and that its replacement be applied on a prospective basis, with the effective date deferred one year for transfers taking place at death. While we recognize that this proposal in effect grants a windfall to those generation-skipping trusts that would be taxable under the current GST tax as well as under the Treasury proposal, we do not feel that it is worth keeping the current GST tax alive simply to govern these trusts. Also, we do not believe it is possible to devise a fair and simple way of applying the Treasury proposal retroactively to existing trusts.

We recognize, however, that a bill that would repeal the current GST tax could create a "window of opportunity" for those individuals willing to create lifetime generation-skipping trusts. We believe that it would not be unreasonable for this Committee to close this window by providing an earlier effective date for lifetime transfers to generation-skipping trusts.

Specific issues on which public comment is requested

Trusts skipping more than one generation

The Treasury proposal is designed to prevent the avoidance of a transfer tax in the generation of the transferor's children. It does not prevent transferors from avoiding transfer taxes in any lower generations.

For essentially two reasons, Treasury decided not to attempt to apply the general principles of its proposal to impose multiple GST taxes on trusts and direct skips

¹¹ The ALI Discussion Draft has a credit of \$417,000, which is equivalent to an exemption of \$834,000 (disregarding the appreciation factor).

¹² The ALI Discussion Draft also taxes distributions of trust income. However, this proposal uses the opposite mechanism for avoiding double tax: a GST tax deduction is given to reflect the income tax to be paid by the recipient.

that avoid tax in more than one generation. First, we think that taxing the first generation skip would largely cure the generation-skipping problem. In our view, most taxpayers would be willing to tie up their property in a trust for one generation or make a direct skip to grandchildren to avoid a transfer tax in their children's generation, but would not be willing to tie up property for two or more generations or make direct skips to great-grandchildren to derive the more remote benefit of avoiding transfer taxes in those lower generations. Second, a truly neutral tax that applied once each generation would be exceedingly complex. For example, under such a system, a distribution from a multi-generational trust to a great-grandchild before the death of the last child would have to be treated as a taxable distribution with respect to the child's generation and a direct skip with respect to the grandchild's generation. Rules would have to be provided for the interaction between these two taxes.

In spite of these concerns, we recognize that it seems anomalous to tax the first generation skip from a trust while letting all subsequent generation skips escape tax, especially in jurisdictions where the Rule Against Perpetuities does not limit the term of the trust. In light of this concern, we do not believe it would be unreasonable to provide that where property continues in a multi-generational trust beyond the death of the last child of the grantor, additional taxes will be imposed on the termination of the interest of each generation in the trust and upon distributions to beneficiaries two or more generations below the level of the last generation to pay a transfer tax on the property. Since a rule of this type would never result in more than one GST tax being imposed at the same time, it could be drafted relatively simply. Statutory language that would accomplish the desired result is attached to this testimony as Appendix A.

Transferability of the \$1,000,000 exemption

Treasury believes that transferability of the \$1,000,000 exemption between spouses is an essential feature of our proposal, especially as it applies to transferability of the exemption at the death of the first spouse. If an individual could not transfer any unused GST exemption to a surviving spouse, he would be forced to choose in many cases between utilizing his GST exemption and maximum use of the unlimited marital deduction. In such a circumstance, it could hardly be said that individuals with a combined estate of \$2,000,000 or less could ignore the GST tax in their estate planning.

On the other hand, Treasury generally did not intend for the transferability of the GST exemption to result in exempt transfers to the issue of a single marriage in excess of \$2,000,000. While we question whether GST-tax-motivated marriages would in fact become prevalent, we would be happy to work with the Committee to identify legitimate concerns and to fashion reasonable solutions.

\$10,000 per year exemption for certain distributions

The Treasury proposal would provide an exemption of up to \$10,000 per year for distributions to certain trust beneficiaries. This exemption would be available only after the death of the grantor and during the lifetime of a child of the grantor and only for distributions to beneficiaries in the grandchildren's generation.

The origin of this exemption lies in the fact that the \$1,000,000 GST exemption creates an incentive for individuals to make fully exempt direct skips to grandchildren or to trusts for the exclusive benefit of grandchildren. These transfers assure that no portion of the exemption will be "wasted" on trusts making distributions to children.

For reasons that have already been discussed, however, individuals of relatively modest wealth will be reluctant to transfer \$1,000,000 (\$2,000,000 in the case of a married couple) in a form that completely skips their children's generation. The proposed \$10,000 exemption will enable these individuals to create a single, partially exempt trust for the benefit of children and grandchildren. If such a trust is created, the \$10,000 exemption for distributions to grandchildren generally will offset any detriment from diminishing the trust by distributions to children.

We recognize that the proposed \$10,000 exemption is only an approximate cure to the problem of assuring transferors of modest wealth that their GST exemption will not be wasted. Hence, we would be happy to work with the Committee to explore alternative solutions to this problem. In particular, we believe that the alternative outlined in the Committee's release of September 18, 1984, allowing for the exemption to be allocated among distributions to children and grandchildren, is worth exploring in greater detail.

Credit for State death taxes

The Treasury Department proposal would allow a credit against the revised GST tax for State "GST" taxes. This would effectively share the revenue raised by the GST tax with the States. Treasury does not have strong views on whether such a revenue sharing mechanism should be a part of the GST tax system, nor on the appropriate level of revenue sharing. It is our view, however that if a credit for State death taxes is allowed against the GST tax, it should be limited (primarily for reasons of simplicity) to State generation-skipping transfer taxes, that is, taxes specifically enacted to parallel the federal GST tax.

Comparison of the Treasury proposal with the ALI discussion draft

In closing, I would like to say a few words about the similarities and differences between the Treasury Department proposal and the ALI Discussion Draft. The various differences as to exemption versus credit, timing, rate of tax, basis for imposing a tax (tax exclusive versus tax inclusive), and other issues have been footnoted in the preceding text.

I would like to emphasize, however, that in overall structure and in generally philosophy, the similarities of the two proposals far outweigh these differences. Both proposals abandon the notion of a tax and exemption level based on the tax profile of a "deemed transferor" in favor of a flat rate of tax and an independent mechanism for removing smaller transfers from the system. Both proposals would apply a tax to distributions out of current trust income, unlike the current GST tax. Finally, both proposals embody the conclusion that a tax must be imposed on direct skips (outright skips in the ALI terminology) in order to prevent avoidance of the tax on distributions and terminations.

Concluding remarks

Again, I would like to thank the Chairman for calling this hearing. I would also encourage the Committee to take action on this issue promptly in the next Congress, with a view toward enacting a new GST tax at the earliest opportunity. Of course, Treasury would be glad to assist the Committee in whatever way possible to fashion a simple, fair and effective tax on generation-skipping transfers.

This concludes my prepared statement. I would be happy to answer your questions.

APPENDIX A

To impose multiple GST taxes on successive generation skips, the Treasury Department Discussion Draft would be amended as follows:

- (1) Section 2611(b) would be amended by deleting paragraph (2) thereof and renumbering paragraph (3) as paragraph (2);
- (2) A new section 2653 would be added, to read as follows:

"SEC. 2653. TAXATION OF MULTIPLE SKIPS.

"(a) GENERAL RULE.—For purposes of this chapter, if—

"(1) there is a generation-skipping transfer of any property, and

"(2) immediately after such transfer such property is held in trust, for purposes of applying this chapter to subsequent transfers from such trust, the trust will be treated as if the transferor of such property were assigned to the 1st generation below that of the individual who was the transferor immediately before the transfer.

"(b) TRUST RETAINS INCLUSION RATIO.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the provisions of subsection (a) shall not affect the inclusion ratio determined with respect to any trust.

"(2) SPECIAL RULE FOR POUR-OVER TRUST.—

"(A) IN GENERAL.—If the generation-skipping transfer referred to in subsection (a) involves the transfer of property from 1 trust to another trust (hereinafter in this paragraph referred to as the 'pour-over trust'), the inclusion ratio for the pour-over trust shall be determined by treating the nontax portion of such distribution as if it were a part of a GST exemption allocated to such trust.

"(B) NONTAX PORTION.—For purposes of subparagraph (A), the nontax portion of any distribution is the amount of such distribution multiplied by the applicable fraction which applies to such distribution.

Mr. GIBBONS. First, Mr. Pearlman, let me commend you and your colleagues in the Treasury Department for having done what I

think is a very workmanlike job and very conscientious job in this very tough subject. I must admit I had a little nostalgia. I thought I was back in my wills and trust class of some 40 years ago, Federal taxation class, because I remember discussing so many of these problems in that environment.

I realize we are dealing with a very sophisticated group of taxpayers here and they did hire the best of talent to help them with these problems. So while complexity is always a problem in administration of any law, this is not nearly as much of a problem as it is in, say, the simple income tax law.

You have had an opportunity to look over the proposal submitted by the American Law Institute. Do you have any comments on its proposal?

Mr. PEARLMAN. Mr. Chairman, in our written statement we point out the differences between the ALI proposal and the Treasury proposal. There are some major differences. I would indicate the consent of an exemption versus a credit. We chose the exemption route. The ALI discussion draft chooses a credit route for eliminating taxpayers from a tax liability. We believe that the exemption route is a preferable route. That is a difference. I don't think it is a significant and a major difference. We feel very strongly that the tax, at least in terms of trust distributions and termination, should be on a so-called tax inclusive basis because it is more in the nature of an analogy to the estate tax.

The ALI discussion draft adopts a slightly different approach and goes to a system which we believe effectively will create a generation-skipping transfer tax system that operates on a tax exclusive basis. We think that doesn't make as much sense. I think those are probably the two most significant of the differences.

There are some other differences, as I mentioned before. The rate is different. The rate of tax is different. The timing of the tax is slightly different. But I would again emphasize that I think, in terms of philosophy, there is so much similarity in these two proposals that, to me, it shows a very broad consensus not only between people sitting at Treasury, but by practitioners and people outside who live with these problems every day.

I would like to emphasize the similarities of the two proposals rather than emphasize the dissimilarities or seek to criticize the ALI proposals, because I think that is inappropriate.

Mr. GIBBONS. Would you elaborate a little more for the committee on the credit approach versus exemption approach? The credit approach being the ALI approach and the exemption approach being your approach. What are the primary distinctions there?

Mr. PEARLMAN. OK. Let me try to do that by first trying to articulate what the objectives are. I think everyone shares the objective of trying to minimize the number of taxpayers subject to the generation-skipping transfer tax. Under the credit approach, if a taxpayer determines that the amount of the generation-skipping transfers are less than the amount of a credit available, he doesn't have to pay the tax. We wanted to do something more than that. We reacted, seriously reacted, to the criticism of complexity by saying we really wanted to take people out of the generation-skipping transfer tax system.

Now, very frankly, I have to tell you, Mr. Chairman, that the credit system probably conceptually is probably preferable. That is, if you analyze what the effect of the credit is on the taxability of generation-skipping transfers, the credit produces conceptually a more accurate result. The reason for that is that it picks up post-transfer appreciation. That is, the full value of the asset is included in the calculation and a credit taken against the value of the generation-skipping transfers.

We made a judgment. And the judgment was that we wanted to say to most taxpayers: You don't have to worry about the generation-skipping transfer tax; you don't have to worry about completing tax returns. And tax advisers who advise people of more modest means, don't have to worry about fully understanding the complexities of the generation-skipping transfer tax. So we said, even though we think the credit may produce conceptually the better result, we opted for the exemption approach, which simply says, if you have assets of less than \$1 million, for example, you don't have to worry about it. You are never going to have a generation-skipping transfer problem and you never have to look at returns or at the tax in drafting wills and trusts.

So for us it was an added incentive to try to make the system more simple.

Mr. GIBBONS. Does your exemption apply to the lifetime gifts? Suppose you had a grandparent who had given in his lifetime, say, x number of dollars to a grandchild and then at death left enough so when added to the lifetime gifts, would hit \$1 million. Just tell me, describe for me, if you can, the interaction of the lifetime gifts and the gifts at death.

Mr. PEARLMAN. OK. We have tried to integrate the gift tax rules and the generation-skipping transfer tax rules as we articulated the exemption. The first thing, let me answer the initial question: Does the lifetime exemption apply to lifetime gifts? The answer is yes, it clearly does. If someone gave a half-million-dollar gift, a direct transfer to the grandchild, for example, clearly the exemption would be available. In addition, the lifetime exemption will not be encroached except to the extent that it is a gift over the amount of the gift excluded for Federal gift tax purposes; that is, it also includes a \$10,000 exclusion.

So if what the Congress determined were relatively nominal gifts made by grandparents to grandchildren, let us say on an annual basis, of several thousand dollars a year that are not viewed as taxable gifts for the gift tax system, they likewise would not be viewed as taxable gifts for the generation-skipping transfer tax system. And they would not encroach into the lifetime exemption. So that people could make their annual gifts to grandchildren and others at that lower generation without worrying about the lifetime exemption being used up.

Mr. GIBBONS. All right. Well, suppose I had made taxable gifts to my grandchild, say, \$900,000, and then at death I left enough to that grandchild to go over the million. What is the impact of that?

Mr. PEARLMAN. All right, you have got \$1 million exemption. To the extent it is used up during your lifetime, it is simply not available on your death.

Mr. GIBBONS. OK, I understand.

Mr. PEARLMAN. Whatever the amount is in your example over the \$100,000 that is transferred in a generation-skipping transfer death, that is going to be subject to the death.

Mr. GIBBONS. I understand. All right.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

I am delighted, by the way, that we are holding hearings on this issue, and I have had a great interest in it since this law was originally enacted.

I appreciate your testimony today. I am sorry we are not considering a bill just simply to repeal what I think is an odious change in the law that occurred several years ago. But trying to focus in on the areas that you have talked about today, Ron, first off, I would like to ask you whether you think it is important for this committee to act as soon as possible on doing something to try to correct the problems that were created by the generation-skipping tax.

Mr. PEARLMAN. Mr. Archer, I think I would respond by saying I think it is important for the committee to act as soon as is reasonably possible. This is a complicated area, as you have pointed out, and as I think everyone recognizes. For that reason, I think, as I commented at the outset of my statement, the fact we are going through this process is a constructive process. We all know we have dealt over the last 6 months with a lot of criticism about the legislative process moving in complicated areas too quickly; that we don't have a chance to react, members don't have a chance to react, the staff doesn't have a chance to react, and certainly the public at large doesn't have a chance to react.

The committee has put specific legislative proposals out there. I think we will all learn something from the testimony we hear, from the technical comments we get. And I think, therefore, reasonable dispatch is desirable. But I think it is well to get that input. My hope is, once this hearing will have been held and the committee will have received input, that early in 1985 this subject can be addressed. And I hope it will.

Mr. ARCHER. Thank you. I was hoping you would say that. Certainly in the 3 or 4 days left to us this session I don't think it would be wise to act, but I hope we would move on it as rapidly as possible at the beginning of the next Congress.

Have you changed your proposal any since it was originally presented last year, or is it intact?

Mr. PEARLMAN. Nothing significant, Mr. Archer. I would be happy to have the details provided to you, but I think there have been no significant changes.

Mr. ARCHER. As a result of all the deliberations during the conference committee, et cetera, you have not made any changes?

Mr. PEARLMAN. Correct; that is correct. We are, I think, based on the kinds of issues we discussed during the conference, essentially where we were.

Mr. ARCHER. Do you feel there is any magic to the 80-percent rate?

Mr. PEARLMAN. I guess I would have to say clearly there is no magic to 80 percent or to \$1 million. But I would say this: I think here is a great importance to the interrelationship between the

rate and the exemption. I emphasized that earlier and want to re-emphasize it again because I know there is no use sitting here kidding ourselves. We know there is pressure to increase that exemption. If we increase that exemption that puts great pressure on that rate. So the thing that is more important to me is not whether someone says, well, what is so magical about 80 percent? What is more important to me is what happens if we start tinkering with either the rate or the exemption and the effect on the others. I think that is the key issue.

Mr. ARCHER. Do you think that there is something particularly wrong for a grandfather to want to leave a direct bequest to a grandson? Does that violate some sort of public policy?

Mr. PEARLMAN. Absolutely not. And I think—I am glad you asked that question.

Mr. ARCHER. Because you are attaching a rate, first off, of 60 percent. Then you are attaching another 80 percent of 60 percent. And you get pretty near the confiscatory level.

Mr. PEARLMAN. Let me—

Mr. ARCHER. So there has to be something wrong in public policy to have that sort of a tax attached to a direct transfer from a grandfather to a grandson.

Mr. PEARLMAN. Let me respond to you this way. What we have tried to say here, the specific response to your question is absolutely not. There is nothing wrong with that. What we have tried to say here is, the tax system shouldn't make that judgment. That right or wrong, good or bad, the tax system should be neutral.

Conversely, at least rhetorically, let me throw a question back to you. In the modest estate where you have grandparent, parent, grandchild, where—let's assume a parent has no assets, grandparent has substantial assets or enough assets that there is a need to deal at the parent level. If the grandparent passes assets to the parent—outright transfer of assets to the parent—and then on the parent's death it transfers assets to the grandchild, there will be two taxes. Yet, in that family situation that may be the most appropriate thing for that family to do. That it would be financially and, from a family planning standpoint, irresponsible for that grandparent to skip that generation. Yet, absent a generation-skipping transfer tax, our tax system would give a premium, an incentive for doing that.

So what I would respond to you, Mr. Archer, is that the tax system shouldn't say, shouldn't comment on whether it is good or bad, one way or another. Should grandparents have an incentive to give assets directly to grandchildren, should they have an incentive to give trust, or outright? I would prefer to let taxpayers and their advisers make those judgments without tax considerations being in mind. That is, that a tax adviser could say it is neutral, doesn't make any difference, make your judgments using your best evaluation of what your family situation is.

So we respond to you saying, the more neutrality we can bring to the transfer tax system, the better we are in getting people to make those kinds of very important decisions on a nontax basis.

Mr. ARCHER. Well, then, inherent in this entire process is a public policy that the Federal Government has a preemptive right

to a percentage of an individual's property every time one generation passes into another generation.

Mr. PEARLMAN. Yes.

Mr. ARCHER. We are making, in effect, that as a public policy statement. And that it is some way wrong not to do that.

Mr. PEARLMAN. I would agree with that. I think that is absolutely correct. That what we have said, I would put it slightly differently, but I think we are saying the same thing. That is, we have a transfer tax system called the estate tax. There is a policy statement made in the estate and gift tax system, transfers of assets, and obviously typically we are talking from one generation to another, are—

Mr. ARCHER. Well, we have not been talking that way in the past. This is a new public policy that is being established in the generation-skipping tax field. That has not been the public policy of this country up until the generation-skipping tax was put into effect.

Mr. PEARLMAN. Oh, I think clearly that Congress said something in 1976 that said, in order to retain, to maintain some integrity into a transfer tax system, if you permit the wealthiest individuals in the country to skip generations, then you are not going to maintain the integrity of your transfer tax system. I would not disagree with you at all that Congress would—

Mr. ARCHER. That was a political judgment which the Treasury now is adopting as a part of its continuation of this policy.

Mr. PEARLMAN. I think it—

Mr. ARCHER. Basically, you know, we can't escape that. Now, what happens—let me ask you, if you have an estate that is \$1,000,001 that is left to a grandchild, then I assume the \$1 million under your proposal would be exempt. But you would then come in and cause the filing of a return for \$1 to pay the extra tax. Is that not correct?

Mr. PEARLMAN. Sure, unless we take that one back and say if you owe a dollar, you don't have to pay a tax. Sure, that always happens in any tax system. I mean we can talk about the poverty level income tax pair that is \$3 above the necessary return filing requirement, and a return is filed. Or we can talk about an estate tax with someone who has the maximum—

Mr. ARCHER. So we are just adding one additional category of that type of application.

Mr. PEARLMAN. But Mr. Archer, permit me to say we are talking about a very substantial exemption level. When you look at the numbers of taxpayers who are going to be excluded from that system, I think any burden of compliance is going to fall on a very small number of individuals in this country.

Mr. ARCHER. You do have a very high incremental tax, though, on the amount in excess of that. Mr. Chairman, I would like to ask just one other question, if I might without unduly imposing on the committee's time.

If you have a grandfather with grandchildren living and the parents of those grandchildren died at the time of the death of that grandfather leaving that property to those grandchildren would be subject to the generation skipping tax, would it not, even though he had no alternative other than to leave it to his grandchildren?

There was no effort to subvert the law or to go around anybody. He would still suffer this penalty, or his grandchildren would suffer this penalty, is that not correct?

Mr. PEARLMAN. That is correct under our proposal. I would like to make a further comment, if you wanted to make one, I wanted to add something to that, however. I think you are correct. Can I go on?

Mr. ARCHER. Sure.

Mr. PEARLMAN. I am troubled by that conclusion, very frankly. While I am concerned, I don't want to see a system where deathbed planning is a way around the transfer tax system. On the other hand, we normally don't plan on deaths of children in order to avoid generation-skipping transfer exclusions. So for us, in spite of the fact that the Treasury proposal does indeed apply a generation-skipping transfer tax in that situation, we would be very willing to work with the committee to try to see if we can at least take the categories of those transactions which aren't going to occur very often anyway out of it. I have some personal difficulty.

Mr. ARCHER. What is the definition of a "different generation"?

Mr. PEARLMAN. It is not an age or a time definition. It is a family lineage definition—children, grandchildren, great-grandchildren.

Mr. ARCHER. If you wanted to give your estate to one you are not related to, how would you know whether there was a generation-skipping effect?

Mr. PEARLMAN. If you are talking about people outside the family?

Mr. ARCHER. Yes.

Mr. PEARLMAN. Then we look at age and just make a judgment about—because we didn't know how else to do it.

Mr. ARCHER. I have a lot more questions. But in deference to the rest of the committee, I will postpone them.

Mr. PEARLMAN. We will be happy to try to answer them in writing, or discuss them with you.

Mr. ARCHER. Thank you.

Mr. RUSSO [presiding]. The gentleman from Arkansas.

Mr. ANTHONY. No questions.

Mr. RUSSO. The gentleman from New York.

Mr. CONABLE. I came in late, Mr. Chairman. I apologize.

Might I ask a summary question? Is this still the proposal which seeks a degree of neutrality between those who give—bypass a generation through a trust instrument, and those who do it directly? The effect being, of course, in some cases under the existing law that the moderately wealthy who need to protect assets through a trust pay a tax which is not paid by the very wealthy who simply make direct transfers to people more than a generation removed from them in lineal line of descent.

Is that generally correct?

Mr. PEARLMAN. That is generally correct. And I would suggest that that is probably the single most important concept in generation-skipping transfer taxes, to try to bring neutrality to them.

Mr. CONABLE. Under existing law, it is possible for the very wealthy who don't worry about the preservation of assets because they are dealing in very large assets, simply pass property to an

individual by direct transfers tax free rather than those which are subject to the protection of the trust.

Mr. PEARLMAN. That is true.

Mr. CONABLE. Is it also true that your provision seeks some definite and positive rate of tax rather than a rate of tax which is very difficult to ascertain simply because it requires establishing a level of taxation based on the wealth of the ultimate donee or beneficiary? Is that correct?

Mr. PEARLMAN. That is correct.

Mr. CONABLE. So you are seeking both equitable improvement and administrative improvement—the administrative improvement leading ultimately to the easier filing of returns, because the rate of tax is definite and certain rather than contingent; is that correct?

Mr. PEARLMAN. That is correct.

Mr. CONABLE. I think something along this line is appropriate. It is complicated. And it is my feeling that the committee may want to have some review of the options relative to achieving these basic results in some other way. But I think the goal is worthy, and I am glad the Treasury has made the effort to resolve not only the uncertainties but inequities in the current law.

Mr. PEARLMAN. Thank you very much.

I want to restate—since you came in, Mr. Conable—our appreciation for your help in having the committee put forth these proposals so we can get public comment.

Mr. CONABLE. My only regret is that we have not dealt with it before this time. It seems to me unfortunate that we have left this important area of law in a virtually irreducible snarl, something that obviously cannot be administered fairly or even with any degree of certainty. I regret it has taken us so long to accomplish this.

Mr. PEARLMAN. We share your regret.

Mr. RUSSO. The gentleman from Pennsylvania.

Mr. SCHULZE. I have no questions.

Mr. RUSSO. Mr. Pearlman, under Treasury's proposal, there is a \$1 million exemption per transfer.

Under your proposal, how many taxpayers would be exempt from the tax, and how many would pay the tax?

Mr. PEARLMAN. Let me refer you, Mr. Chairman, to pages 14 and 15 of the written statement, simply to indicate to you that we give you some information that may be helpful. Let me just review a piece of it with you.

Just taking 1988 as a hypothetical year, we estimate 2 million people dying in 1988; 9,000 will have gross estates in excess of \$1,250,000. On a percentage basis, that means 35 percent of 25,800 decedents who have estates subject to Federal tax will be over \$1,250,000; and less than 1 percent—0.45 percent—of all decedents dying would have estates over that amount. Just using \$1.25 million, you can see that the vast majority of taxpayers would be subject to the Federal estate tax, and obviously virtually none of the people dying in this country would be swept into this system.

Yet I want to emphasize that we think that it is an exemption level that does pick up—does not exclude from the generation-skip-

ping transfer tax—those taxpayers and estates that should be subject to the tax.

Mr. RUSSO. The gentleman from Texas.

Mr. ARCHER. Ron, I think we have taken enough of your time. I will talk to you or send the questions to you in writing as we go along here.

Thank you very much.

Mr. PEARLMAN. Thank you.

Mr. RUSSO. Thank you, Mr. Secretary, for your testimony.

Our next witness is Harry Gutman, American Law Institute, professor of law, University of Pennsylvania.

Welcome to the committee, Mr. Gutman. Your statement will be made a part of the record, without objection, and you may proceed as you wish.

STATEMENT OF HARRY L. GUTMAN, PROFESSOR OF LAW, UNIVERSITY OF PENNSYLVANIA, AND REPORTER, AMERICAN LAW INSTITUTE PROJECT ON GENERATION-SKIPPING TRANSFERS

Mr. GUTMAN. Thank you.

Mr. Russo, Mr. Conable, and other members of the committee: It is an honor for me to be here to discuss with you the general question of the appropriate structure of a tax on generation-skipping transfers, and to comment specifically on H.R. 6260 and H.R. 6261.

I would like, at the outset, to clarify something. The statement I am submitting for the record, and also my comments today, are being made in my individual capacity. I have been the reporter for an American Law Institute project which over the last year and a half has studied generation-skipping transfers. That project has culminated in a discussion draft, and H.R. 6261 constitutes the statutory language implementing the proposals that are contained in that discussion draft.

However, the discussion draft has not been adopted either by the American Law Institute or by its council. Therefore, the comments I am about to make are in my capacity as an individual who did this project with others for the American Law Institute. With that caveat, I will proceed to go through my statement. Also I would like to submit for the record a copy of the ALI discussion draft.

Mr. RUSSO. Without objection, it will be included in the record.

Mr. GUTMAN. I would like to commend the committee for holding this hearing today. The chairman's statement that a tax on generation-skipping transfers is an essential element in a fair and comprehensive tax on wealth transfers ought to be an important signal to people who are involved in this issue. It indicates that our discussions ought to focus on the reformation of the existing generation-skipping tax; not simply its repeal.

When coupled with this hearing, the chairman's statement assures that the process of reformation will be deliberate and considered. I think that when we are dealing with an issue like this, it is important that the committee take the time to try to sort out the various competing considerations in order to rectify the actual problems with the existing tax.

The ALI project began in January 1983. The purpose of the study was to take a fresh, objective look at the question whether, in the

context of the existing estate and gift tax, chapters 11 and 12 of the code, untaxed generation-skipping transfers caused a problem when analyzed in light of the equity, efficiency, and administerability criteria usually associated with the evaluation of a good tax system.

To put it differently, the question was whether the coverage accorded wealth transfers under the existing estate and gift tax was sufficiently comprehensive; and if, after the examination of that question, we decided that there was a problem, the reporters for the American Law Institute project were charged with the further responsibility of trying, within the context of an estate and gift tax, to devise a simple and administrable solution to the problem. We did not consider, and were not authorized to consider, alternative forms of wealth taxation such as accessions tax.

After an independent study, the two reporters on the project—Joseph Kartiganer, from White & Case in New York, was the other—concluded that untaxed generation-skipping transfers do cause a transfer-tax problem. We had a number of consultants assisting us in trying to evaluate the nature of the problem, and also to come up with solutions, and they concurred, although not unanimously. The tax advisory group of the American Law Institute also concurred.

I think that is very significant. It reconfirms the conclusions that underlie the 1968 ALI Federal estate and gift tax recommendations, 1969 Treasury proposals, and also the 1976 findings of this committee with respect to the need to tax generation-skipping transfers. It also reinforced the view of the Treasury Department that the repeal of chapter 13 is acceptable only if an effective and administrable alternative is enacted in its place.

Now, if you would allow me an indulgence for a few minutes, I would like to exercise a privilege as a teacher and try to analyze what it is we are talking about. First of all, what is this thing we call the generation-skipping transfer? Until we know what it is, it is hard to say why we ought to care about it. A generation-skipping transfer is a transfer of property in which the ultimate ownership of that property ends up in the hands of an individual who is a member of a generation more than one below that of the original transferor, at the cost of just one transfer tax imposed at the time of the original transfer.

That is how we describe a generation-skipping transfer. But that is a pretty arid description. I don't think we get the sense of what is going on simply by describing what it is that a generation-skipping transfer is described as.

Perhaps a better way to focus on the question is to take a simple example. For those of you who were on the committee in 1975, the example will be familiar. Professor Casner from Harvard gave you a similar example at that time.

Assume for a moment that a client comes into his lawyer's office with \$2 million. Assume further that we have an estate tax with 50-percent rate, and without exemptions or credits. When this individual dies the tax imposed on the estate will be \$1 million and he will have a million left to transfer to his son. He comes in to the lawyer and says, "I want you to write me a will. I want to leave all my property outright to my son." The lawyer says, "Fine. I will be

happy to write that will for you. But before I do it, can we examine a couple alternatives?" The client says, "Yes, certainly, let's talk about a couple other alternatives."

The lawyer asks the client, "Suppose your son dies with this property and it has not all been consumed by him, and he will pass it, say, to your grandchildren. Do you care about saving any taxes then?" And the client says, "Well, yes; I guess I care about that. If you can show me a way that lets my son basically have control of the property and give it to whoever he wants, without paying a second tax when he dies, I will certainly consider that."

This is a very clever lawyer. He says:

Consider this: You are going to die and you will have to pay that \$1 million in tax; no question about that. But why don't we set up a trust. Here is what we can do in that trust. First of all, we will give your son the income for life—that is, as if he had the money—and spend the income from it.

Of course, you want more than that. You want your son to be able to get his hands on the money if he needs it. Well, we can certainly take care of that. We will give the trustee discretion to give property to your son if he needs it for his health, maintenance, education or support.

The client is beginning to look a little interested in this proposition. But he says, "You know, my son can only get the property for health, maintenance, education or support. Suppose he just wants some?"

"Well," says the lawyer, "I can take care of that, too. He can't get all of it, but I can give him the right to withdraw the greater of \$5,000 or 5 percent of the trust corpus each year. All he has to do is ask for it."

Now it looks pretty good. But the client says, "Remember, I told you I wanted him to be able to give it to whoever he wanted to." The lawyer says, "That's OK. I can take care of that, too. I can give him the power to appoint this property during his lifetime or at death. He can give it to anybody he wants to during his lifetime, or at death, as long as he doesn't give it to himself, his estate, his creditors, or creditors of his estate."

The client is very happy about this, but he says, "You know, there is one last thing: I don't trust people to manage these assets. I would like my son to be able to manage them."

The lawyer says, "You know what? We can do that, too."

The client then asks, "What have we accomplished?" Well, what we have accomplished is this: If the man dies with \$2 million, he pays \$1 million in tax at his death. If the property passes outright to his son, and the son, for purposes of illustration, simply consumes the income and dies with \$1 million, his estate has to pay \$500,000 in tax. The total tax paid will have been \$1,500,000. The grandson will end up with only \$500,000.

The device I have just suggested eliminates the second tax. Under chapters 11 and 12, the current estate and gift tax, we can give all of those powers and interests to somebody in the intervening generation. That looks an awful lot like ownership to me. Nonetheless, the tax system doesn't treat them as ownership. So on the death of the son, the million that is left in the trust goes over to the grandson unreduced by any taxation. That is a very interesting world.

Prior to 1976, that is exactly the world we lived in. Prior to 1976, we could give all of those powers and interests in a trust to a beneficiary in an intervening generation and there would be no tax when that beneficiary dies. Now, that kind of transaction is what this hearing is all about.

Notice what has happened: The client, simply by using a trust, has managed to pass a half million dollars more wealth on to his grandchildren. He has managed to pass a half million more on to the ultimate beneficiary simply by the use of the trust.

Now, what effect does that have on the tax system? If we look at the total tax paid in the process of wealth transmission, we see that rather than having paid 75 percent tax on these two transmissions, he only paid 50. So the effective rate of tax on the transmission of wealth between the generations is considerably lower because of the form of the disposition.

If the property had passed outright—which, as Mr. Pearlman said, is the way most people actually devise their property, there would have been two taxes. So, we have a preference here for a form of disposition that avoids the tax in the intermediate generation.

Notice, I said that the client came into the office and his initial thought was to give the property outright. That is what he wanted to do. What I have shown is that the use of a trust gives him a tax preference. All other things equal, he will choose the trust. Therefore, we have a nonneutral system with respect to the selection of form of disposition of property. Taxpayers, all other things being equal, will select a tax-preferred way of giving property, in this case through a trust.

What we can also see from this example is that the ability to make tax-free generation-skipping transfers can seriously erode the tax base.

The existing data, although it is rather sketchy and rather aged, demonstrate that taxpayers, not surprisingly, do this. They use these arrangements. The use of these arrangements also, as you would expect, is principally by wealthy taxpayers. As a result, this self-selected group of taxpayers has been able to effect reduction of tax burden on their wealth transmissions when compared to the people who pass property outright from generation to generation.

That result gives us a horizontal equity problem. People transmitting similar amounts of wealth through generations pay differing amounts of taxes. That is not a particularly fair system.

We also have a progressive rate structure that applies higher rates of tax to larger transmissions of wealth. That system is frustrated to the extent someone can avoid tax in the intermediate generation.

Finally, the failure to tax generation-skipping transfers creates a bias in favor of dispositions in trust, and that effect violates the principle that a tax system ought to be neutral with respect to the choice of a form of disposition of property.

In 1976, after a long and hard struggle, as Mr. Gibbons said when he opened the hearings, and as Mr. Rostenkowski and Mr. Conable have both said in the past, Congress enacted a tax to do something about this, and that was the generation-skipping tax. It

is instructive, I think, in the context of today's hearings to go back and review why the committee felt this tax ought to be imposed.

The committee stated at that time that the new tax was necessary to assure that the transfer tax applies to taxpayers as nearly as possible on a uniform generation-by-generation basis. That, of course, is the question Mr. Archer was discussing with Mr. Pearlman. The committee also enacted the tax to reduce the relative advantage generation-skipping afforded wealthier families, to restore progressivity to the taxation of intergenerational wealth transfers, and to restore neutrality in the tax treatment of wealth transfers.

That was the purpose behind enactment of chapter 13. If chapter 13 is repealed, all those problems come back again. Congress once before decided those problems should be taken care of. I don't think this is the time to step back and say that it was wrong. In fact, I believe Congress was very right in enacting chapter 13 in 1976. However, chapter 13 does have some problems. Chapter 13 has been criticized by many as unworkable. Others have criticized it as creating its own set of inequities and unfairnesses.

In particular, the opportunity to make a direct or outright generation-skipping transfer has been criticized. In the situation I gave you as our hypothetical, we gave a member of an intervening generation all kinds of interests in and powers over the trust. Chapter 13 deals with that situation and imposes a transfer tax on the expiration of that intervening generation beneficiary's interests in or powers over the property. But chapter 13 does nothing about a transfer that only the wealthiest of our taxpayers can make; a transfer directly to, say, a grandchild without any intervening generation having an interest in or power over that property. In this respect, the existing law has been criticized as creating a preference for the super-wealthy. That is what Mr. Conable was talking to Mr. Pearlman about at the end of Mr. Pearlman's discussion.

In summary, chapter 13's purposes were, I think, laudable, and the need for chapter 13 still remain so. But the chapter 13 has some problems that have to be worked out.

You have heard this morning from Mr. Pearlman, discussing with you the Treasury's proposal to subject generation-skipping transfers to tax. You also have before you H.R. 6261, which is a statutory implementation of the American Law Institute Discussion Draft.

I would like to reiterate what Mr. Pearlman said about these bills. They are striking not so much in their differences, but in their similarities. Both attempt to reach the same goals of equity and neutrality and simple administration. They both try to eliminate computational complexity by subjecting transfers to a flat tax rate. Both include distributions of income and principal in the tax base. Both exempt distributions in payment of medical or tuition expenses of beneficiaries. Each imposes a single tax no matter how many generations are skipped. Most importantly, both contain provisions to bring direct or outright skips within the ambit of the tax.

I don't intend to go through the technical details of H.R. 6261 or H.R. 6260. I have dealt with them in my written statement and the discussion draft. I would just like to comment that I think both bills represent significant improvement over current law. They are both relatively simple to administer.

I happen to have a preference for H.R. 6261, perhaps it is just pride of authorship. But I must point out that the operation of H.R. 6261 is very simple. All we need to know in order to figure out whether a generation skipping transfer has occurred in the case of transfers from trusts is the generation assignment of the recipient of the property. It doesn't matter how the trust is drafted; all we need know is who is getting the property. If that person is assigned to a generation that is more than one below the transferor, there will be a taxable event.

The tax computation is simple. The flat tax rate is applied to the amount of the distribution and a tentative tax is computed. Against that tentative tax, a rather substantial credit is available.

So, all we need to know is the identity and generation assignment of the beneficiary; how much has been distributed; as a technical matter, in order to make an adjustment because of the interplay between the income and transfer tax, the amount of taxable income that the distribution includes; and the amount of somebody's credit. All we have to do then is push a pencil around and do a little multiplication and a little subtraction.

The taxation of an outright skip is just as simple. If the outright skip occurs at death, all the fiduciary needs to know is how much was transferred and the remaining amount of the decedent's generation-skipping tax credit. If that transaction takes place while the transferor is alive, he needs to know his own transfer tax bracket as well.

We are not talking about tedious computational complexity. It is all rather simple in my judgment.

In closing, I would like to comment on a number of specific policy questions. The first is one that Mr. Pearlman addressed and about which I am sure you will hear a lot more today. That is the taxation of direct or outright skips.

I am sure you will hear today from people who are going to tell you that imposing a surtax on direct skips is revolutionary. Others will say it was rejected by Congress when it was suggested in 1976. Of course, if it has been suggested before, it is hardly revolutionary. Nonetheless, there will be those who say it is revolutionary. There will also be those who will say a tax on direct skips is theoretically inconsistent with a tax that is imposed on transfers.

Well, the concept isn't new. First it was suggested in the 1969 "Treasury Tax Reform Studies and Proposals." Second, it is difficult for me to see how the alleged rejection of the concept 8 years ago ought to preclude consideration of the concept today in light of the experience that we have had under chapter 13 and the plain, it seems to me, equity and neutrality gains achieved if the direct skips are subject to tax.

Finally, it seems to me that the argument that an additional tax on direct skips is inconsistent with the theory of the tax imposed on transfers, while having some superficial appeal, is too simplistic a way of looking at the problem. One purpose of the generation skipping tax is to assure periodic imposition of the transfer tax no matter what form the disposition takes. The Treasury reiterated that goal today. That was a specific goal of the generation-skipping tax when enacted in 1976. The object is to attempt to assure that a transfer of property to a beneficiary in remote generations bears

approximately the same tax burden as that which would have occurred had the property actually passed through the tax base of a member of each intervening generation.

If we assume that a tax is going to be imposed on generation skipping transfers in which a member of an intervening generation possesses an interest or power over the property, and that is the hypothetical situation I gave you earlier, the failure to tax outright skips results in incomplete coverage. It creates a distinction between those who transfer property directly to beneficiaries more than one generation below the transferor, and those who do not. That violates the neutrality principle because the lower tax burden will induce direct skips as opposed to other dispositions. As a result, it ought to be clear that the taxation of direct skips is essential to a fair and neutral generation-skipping tax.

As I said to you, the major policy decision in the two bills are similar. There are a number of differences, to which Mr. Pearlman alluded, and they are set out in my statement. There is one major difference that I would like to address now, and that is the question of how we remove taxpayers from this system. We don't want all taxpayers to be covered by the system. The question is how we remove them.

The Treasury has suggested a \$1 million exemption. It is an individual exemption, so, therefore, if an individual is married, the exemption for the spouse is \$2 million, and that exemption is freely transferable.

We have suggested a tax credit as the method of limiting the application of the tax. The number we have picked is \$417,000. There is no particular magic to that number. It represents the value of one run up the transfer tax rate schedule and one unified credit when all of the estate and gift tax rate and credit changes are fully effective.

It is easy to see why some would prefer to limit the scope of the tax through an exemption. As Treasury has said, a trust that contains only exempt property doesn't have to keep any records. At \$1 million, their data tell you there won't be many taxpayers affected by the system; so many taxpayers, if not most, could ignore the tax for estate planning.

There is also a pragmatic political reason for selecting an exemption. If the effect of the exemption is to limit the application of the tax to just a few taxpayers, it is difficult for opponents of the tax to argue plausibly that practitioners won't be able to cope with its intricacies. It simply won't affect them.

Mr. Russo. If I may interrupt, I don't want to impose on you, but we have an entire panel here today, and what I would like to do is try to get the testimony summarized as quickly as possible because I am concerned we will have a series of votes that will pull us away.

Mr. GUTMAN. No problem.

Mr. Russo. I would ask you to summarize, as well as the other witnesses. I know it is a complicated subject, and I want to be sure you have been given an ample opportunity. But there comes a point when we have to move the committee, and I would appreciate your summarizing.

Mr. GUTMAN. No problem, I will finish by making just one point and then take any questions you may have.

I think there are real differences between an exemption and a credit. The principal difference lies in the fact that if you grant an exemption, all the post-transfer appreciation in the property is out of the base. Mr. Pearlman said that. He told you that he thought conceptually, a credit would be a better approach.

There is another aspect to the exemption I would like to bring to your attention. I would be worried that an exemption is an invitation—well, invitation is perhaps too strong—it may foster serious avoidance problems because there is no way for the Internal Revenue Service to audit, at least under current law, an exempt trust. By definition, nothing that comes out of that trust will be subject to tax. Nothing will be subject to tax until an individual has it in his transfer tax base later.

I can foresee problems with individuals putting property into trust and undervaluing that property or leveraging that property in an attempt to maximize the advantages of the exemption. There is no way the Service can monitor that.

I consider that to be a serious defect of an exemption. Once the property is in trust and the exemption is claimed, there is no mechanism, at least under current law, to be able to figure out whether the exemption was properly claimed. So if the committee prefers to use an exemption, and there are arguments for the use of the exemption, it seems to me that it then has to face the question of how it is going to police the exemption.

There are other points that I have made in the statement, Mr. Russo. I will let the statement speak for itself on those and would be happy to take questions you may have.

[The prepared statement and attachment follow. Oral testimony continues on p. 266.]

STATEMENT OF HARRY L. GUTMAN, PROFESSOR OF LAW, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL AND REPORTER FOR THE AMERICAN LAW INSTITUTE

Mr. Chairman, Mr. Conable and members of the committee, my name is Harry Gutman. I am a Professor of Law at the University of Pennsylvania Law School and the Reporter for the American Law Institute ("ALI") Project on Generation-Skipping Transfers. I am honored to have been invited to discuss the general question of the appropriate structure of a tax on "generation-skipping" transfers and to comment specifically on H.R. 6260 and H.R. 6261.

I commend the Committee for holding this hearing. The Chairman's statement that a tax on generation-skipping transfers is an essential element in a fair and comprehensive tax on wealth transfers is an important signal. It indicates that discussion should focus on the reformation of Chapter 13, not simply its repeal. When coupled with this hearing, it assures that the process of reformation will be deliberate and considered.

This statement contains my individual views. These views do not, either explicitly or implicitly, represent positions of the ALI. The contents of ALI Generation-Skipping Discussion Draft have not been formally approved or disapproved by either the Council or the full membership of the Institute.

With this caveat, I am submitting a copy of the ALI Discussion Draft for inclusion in the hearing record. The Discussion Draft represents more than a year's work by me and the Associate Reporter, Joseph Kartiganer of White and Case in New York City. It is the product of two meetings with our consultants and one meeting of the ALI Tax Advisory Group. The Draft has also been discussed at one meeting of the ALI Council and one meeting of the ALI membership.

H.R. 6261 is a statutory draft of the proposal described in Part I of the Discussion Draft. Part II of the Discussion Draft is a detailed explanation of the proposal. Part III is a commentary that discusses alternatives that were considered and rejected.

Appendices A, B and C contain the Reporters' study of the question whether the failure to tax generation-skipping transfers causes a problem in the transfer tax structure. Appendix D contains a description of the Treasury generation-skipping tax proposal (H.R. 6260) and notes some of the major differences between it and H.R. 6261.

BACKGROUND

The ALI Study on Generation-Skipping Transfers began in January, 1983. It was commissioned against the background of mounting dissatisfaction with, and calls for the repeal of, the tax on certain generation-skipping transfers (Chapter 13 of the Internal Revenue Code) that had been enacted as part of the Tax Reform Act of 1976. The Study was to take a fresh, objective look at the question whether, viewed solely in the context of the existing estate and gift taxes (Chapter 11 and 12 of the Internal Revenue Code), untaxed generation-skipping transfers caused a problem when analyzed in light of the equity, efficiency and administrability criteria usually associated with a "good" tax system. Put differently, the question was whether the coverage accorded wealth transfers under the estate and gift tax was sufficiently comprehensive. If this examination revealed the existence of a problem or a gap in coverage, the Reporters were to propose solutions consistent with a tax imposed on wealth transfers. Alternative systems of wealth taxation, such as an accessions tax, were not to be considered.

After an independent study, the Reporters concluded that untaxed generation-skipping transfers cause a transfer tax problem. The consultants and Tax Advisory Group concurred. This is significant. It reconfirms the conclusions underlying the 1968 ALI Federal Estate and Gift Tax Recommendations, the 1969 Treasury Department Tax Reform Studies and Proposals and the 1976 Congressional findings with respect to the need to tax generation-skipping transfers. It reinforces the view of the Treasury Department that the repeal of Chapter 13 is acceptable only if an effective and administrable alternative is enacted in its place. It also provides an independent basis for the Chairman's statement, in introducing the bills to be considered today, that "a generation-skipping transfer tax is an essential component of a fair and efficient Federal transfer tax system."

WHAT IS A "GENERATION-SKIPPING" TRANSFER?

There are three generic types of generation-skipping transfers. The first is a transfer, in trust or otherwise, pursuant to which a person, who is a member of a generation below that of the transferor and above that of the ultimate recipient of the transferred property, possesses some form of economic interest in the transferred property but not an interest sufficient to cause inclusion in his transfer tax base of the property in which he has an interest. The economic interest may be fixed; for example, a transfer by a father of property in trust to pay the income to his son for life, remainder to his grandson. Alternatively, receipt may be in the discretion of a third party; for example, a transfer in trust to a third party trustee with unfettered discretion to pay or accumulate income and/or principal for the benefit of the grantor's child for life, remainder to grandchildren.

The second is a transfer, in trust or otherwise, pursuant to which a person other than the transferor, who is a member of a generation below the transferor, has the power to direct the economic benefits of the transferred property to members of a generation below the power-holder, but cannot himself benefit economically from the exercise of the power. A typical disposition of this type is a transfer to a child as trustee to distribute, in his discretion, income and/or corpus to the grandchildren of the grantor until the youngest grandchild attains a fixed age, with distribution of the remaining trust corpus to the grandchildren at that time.

The first and second types of transfers may be combined so that a person possesses both an economic interest in the transferred property and a special power to identify the ultimate takers of the transferred property. A typical disposition of this type is a transfer of property in trust to pay the income to the grantor's child for life, remainder to such others as the child shall select.

The combination of non-taxable interests in and powers over transferred property can come very close to the substantive equivalent of outright ownership. An individual may possess the following interests in and powers over transferred property without causing that property to be included in his or her transfer tax base: "(1) the right to receive the income from the trust; (2) the power to invade the principal of the trust, if this power [is] subject to an ascertainable standard relating to health, education, support, or maintenance; (3) a power . . . to draw down annually from . . . the principal the greater of 5 percent of its value or \$5,000; (4) a power, exercis-

able during life or by will, to appoint any or all of . . . the principal to anyone other than [the holder], his creditors, his estate or the creditors of his estate; [and] (5) the right to manage the trust property by serving as trustee." ¹ Transfers that skip generations may skip a single generation or may be used to postpone transfer tax incidence until the expiration of the applicable local law version of the Rule Against Perpetuities.

The third type of generation-skipping transfer is a transfer in which no member of an intervening generation possesses an interest in or power over the transferred property. An outright transfer of property from a grandfather to his grandchild when there is a living child is the paradigm. A transfer by a grantor to his wife as trustee to pay income to a grandchild for a term of years and then to distribute the corpus to the grandchildren is another example.

The foregoing illustrates the extent to which generation-skipping transfers may be made under the existing estate and gift tax structure. While the form and duration of the arrangements differ, all share one common characteristic. Ultimate ownership of the transferred property passes to individuals separated from the transferor by an intervening generation at the cost of a single excise levied upon the original transferor at the tax rates applicable to his cumulative transfers at the time of the transfer.

CRITERIA USED TO DETERMINE THE EFFECTS OF GENERATION-SKIPPING TRANSFERS

One could approach the generation-skipping question by asking whether the opportunity to make tax-free generation-skipping transfers is consistent with the objectives of the wealth transfer tax. The major difficulty with this approach is that apart from the revenue raising objective, there has never been any clear consensus among academics, tax professionals or politicians, as to the objectives of the transfer tax. Rather, over the years a number of different themes have emerged: taxation of windfalls, taxation to reduce wealth concentration and taxation of the special ability to pay that is allegedly indicated by the very existence of property gratuitously transferred.² The taxation of property once a generation is also a recurring theme.³ If accepted as an independent objective of the transfer tax, it means that all generation-skipping transfers must be subject to tax.

Even if taxation of property once a generation is not accepted as an independent objective of transfer taxation, one must still face the question how often in the wealth transmission process tax should be imposed. The answer is not implicit in the statement of any other objective of the wealth transfer tax. For example, increased revenue needs may be met by raising rates and/or lowering exemption levels. Wealth concentrations will be diminished if generation-skipping transfers are subject to tax; the tax would simply remove the tax preference accorded wealth dispersion among younger generations. However, the question may also be approached by asking whether tax-free generation-skipping transfers are consistent with the criteria commonly applied to evaluate taxes of any kind.

1. *Horizontal equity.*—The principle of horizontal equity means that similarly situated taxpayers should bear similar tax burdens with respect to events that fall within the scope of the tax. Horizontal equity in the wealth transfer tax has traditionally been tested only against the tax base of the original transferor of property. The implicit assumption has been that the existing system properly describes the taxable event as the transfer of an interest in property and, further, that interests in property are, by and large, properly defined.

While this is a plausible way to test the application of the principle of horizontal equity, in my judgment it is unduly limited because it does not examine the effects of the system beyond taxation of the transferor. I believe the horizontal equity of the existing transfer tax should be evaluated by examining whether the process of wealth transmission from the original transferor to the ultimate recipient results in similar tax burdens no matter what form the original transfer takes.⁴ Under this

¹ Staff of Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 564 (Jt. Comm. Print 1976). The value of the property subject to an annual "5 and 5" power that has not lapsed at the death of the holder will be included in the holder's gross estate under § 2041.

² C. Shoup, "Federal Estate and Gift Taxes" 100-101 (Brookings 1 1967) [hereinafter cited as "Shoup"].

³ Id. at 101; Jantscher, "The Aims of Death Taxation, in E. Halbach, Ed., "Death, Taxes and Family Property: Essays and American Assembly Report" 46 (West 1977).

⁴ See Andrews, "What's Fair About Death Taxes?", 26 Nat. Tax J. 465, 466 (1973).

view, horizontal equity is achieved when two conditions are met: (a) similarly situated transferors have borne similar tax burdens with respect to their transfers, and (b) the process of wealth transmission has resulted in similar tax burdens upon property received by the ultimate transferee. This broader concept of horizontal equity introduces the question of the necessity for a tax at each generation level.

2. *Vertical equity.*—The differentiation in the tax burden borne by those with different levels of wealth transfers is expressed by the progressive rate schedule applicable to cumulative transfers. There is no "absolutely correct" level of progressivity. It is a political judgment. However, it is important to recognize that vertical equity, as expressed by the nominal rates of tax imposed by the progressive rate schedule, is affected if horizontal equity is violated. If horizontal equity is not achieved, the actual effective rate of tax on wealth transmissions by favored taxpayers varies from the nominal effective rate. When that occurs, the progressivity of the system is undermined with respect to those taxpayers.

3. *Neutrality.*—Any system of taxation should intrude as little as possible on non-tax decisions. When applied to the wealth transfer tax, the concept of neutrality dictates that the tax structure should not favor one form of wealth transmission over another.

4. *Administrability.*—The economic costs of administration, planning and compliance should be kept as low as possible consistent with the equity and neutrality objectives of the system. In assessing the administrability of any tax system, the full range of transactions costs must be taken into account. The direct costs to the government of administering the tax and to affected taxpayers in complying with it are obvious. Not so obvious, more difficult to quantify, but nonetheless important are other costs, such as professional fees incurred in planning to meet or minimize anticipated tax burdens, educational costs incurred in mastering the technicalities of the tax statute, and social costs associated with perceptions of the "fairness" of the system. In addition, any change involves costs; professionals must re-educate themselves, affected taxpayers must review and possibly revise existing plans and administrators must adjust their collection and compliance operations. Recognition of these "start-up" costs are particularly important in assessing proposed change.

THE EFFECTS OF GENERATION-SKIPPING TRANSFERS

The characteristic common to all forms of generation-skipping transfers is that ultimate ownership of transferred property passes to individuals separated from the transferor by an intervening generation at the cost of a single transfer tax. Since this is the common characteristic of all forms of generation-skipping transfers, analysis should commence with an examination of the consequences of the allowance in a tax on wealth transmissions of any generation-skipping transfers.

For purposes of this analysis, one must assume a standard disposition against which the consequences of generation-skipping may be compared. The obvious standard is wealth transmission directly from one generation to the next. For purposes of simplicity, I first compare the effects of single generation skips. The effects of multiple generation skips are explored thereafter. Finally, I summarize existing empirical data and anecdotal evidence in an attempt to quantify their effects.

1. *Horizontal equity and the single generation skip.*—Generation-skipping violates the principle of horizontal equity. This is simply illustrated. Assume a tax structure which taxes the first \$500,000 of transfers at 25% and the next \$500,000 of transfers at 50%. A with child B and grandchild C dies with \$1,000,000 of assets. If A leaves the \$1,000,000 net of tax to B, B receives \$625,000. If B in turn consumes the income from the fund and leaves \$625,000 net of tax to C, C receives \$437,500. A's original fund of \$1,000,000 has been reduced by \$562,500 or 56.25% by the imposition of successive transfer taxes. D, with same assets, leaves \$1,000,000 net of tax to a trust to pay the income to child E for life, remainder to grandchild F. F receives \$625,000. While the \$1,000,000 wealth of A and D is taxed identically at their respective deaths and the intervening generation beneficiaries, B and E, each receive the same benefit, the form of the wealth transmission results in C receiving \$187,500 less than F.

To be sure, B could have consumed the corpus of the \$625,000 fund. If one were to introduce that possibility into the analysis, D could assure that corpus is available to E by permitting E to withdraw corpus pursuant to an ascertainable standard, or by authorizing an independent trustee to distribute corpus to E. In other words, the transfers by A and D may be made in a way that treats the intervening generations virtually identically as a substantive matter while preserving a differential in the amount received by the ultimate transferee.

2. *Vertical equity and the single generation skip.*—The foregoing example shows that, under the given rate assumptions, the effective rate of tax paid on the A-B-C wealth transmission was 56.25 percent, while the effective rate of tax paid on D-E-F transmission was 37.5 percent. The generation skipping transfer is taxed at a rate that is 66.6 percent that of the outright transfer. Or put differently, the rate of tax on the outright transfer is 150 percent that of the rate on the generation-skipping transfer.

3. *Neutrality.*—The opportunity to avoid tax through generation-skipping transfers creates an incentive to dispose of property in a tax minimizing manner. All other things being equal, the use of trusts or annuity/remainder arrangements are tax preferred. This analysis contradicts the assertion that subjecting generation-skipping arrangements to transfer taxation is a tax penalty. Generation-skipping arrangements are not penalized. Rather, their advantages are eliminated. The tax system becomes neutral with respect to the selection of a form of wealth disposition.

4. *Multiple generation skips.*—The same equity and neutrality issues exist where more than one generation is skipped. However, the relative advantage of multi-generational skips is less than that attained by a single generation skip. In other words, in relative terms, the greatest inequity is created by a single-generation skip. This occurs because the single generation skip produces the largest base erosion.

The proposition is demonstrated by the following excerpt from Professor Shoup's classic study, *Federal Estate and Gift Taxes*, in which it is assumed that the estate tax base is a circulating fund of constant size and that generations skipped are of constant duration. Then, if all decedents leave all their property in trusts that skip only one generation, 50 percent of the estate tax base is lost. . . . If all decedents leave all their property in trusts that skip two generations instead of one generation, the estate tax base is one-third what it would be under no skipping, instead of one-half. The reduction in base, from what it would be under one-generation skipping, is from 50 to 33 1/3 (with 100 as the base under no skipping). This is a decrease of one-sixth (16 2/3 percent) of the base under no skipping. Three-generation skipping reduces the base from 33 1/3 to 25, or by one-twelfth of the base under no skipping. Thus the big erosion occurs with one-generation skipping. Further skipping is proportionately much less serious.⁵

5. *The empirical data.*—If all transferors utilized generation-skipping arrangements to precisely the same extent, the equity issue would disappear and the neutrality issue would become moot. However, not all transferors utilize generation-skipping arrangements. Moreover, to the extent that generation-skipping arrangements are in fact utilized more extensively by wealthy transferors, horizontal and vertical inequity are even more pronounced than the disparity indicated by comparing transferors at equal wealth levels.

Empirical data on the extent to which generation-skipping arrangements are utilized and the duration of the arrangements that are created are both sketchy and aged. The findings of the most extensive, and most current, empirical survey of the extent and duration of generation-skipping transfers are set out in some detail at pages 124 through 145 of the Discussion Draft. The data indicate that wealthier taxpayers make more use of generation-skipping arrangements and that most generation-skipping arrangement skip only a single generation.

6. *Anecdotal evidence.*—It is, of course, dangerous to rely too heavily upon anecdotal evidence in analyzing an issue susceptible of empirical resolution. However, the fact remains that the existing data is dated. Thus, one must rely on the impressions of those who actually practice in the area to ascertain the extent to which the empirical data should be adjusted. Moreover, since Chapter 13 was enacted in 1976, the most useful information for purposes of determining the effect of generation-skipping on the transfer tax system is that relating to experience prior to 1977. Post 1976 experience is relevant to a different issue—the extent to which the 1976 amendments are effective in eliminating the problems are posed by generation-skipping.

A number of general points may be made. First, estate planning became more important due to the fact that a greater number of decedents had estates of sufficient size to be concerned with consulting a professional with respect to tax minimization techniques. Second, law schools developed specialized courses in estate planning, thus introducing new generations of lawyers to the tax benefits available through the use of generation-skipping transfers. Third, the growth of continuing professional education programs served to inform a wide range of practitioners at all levels of

⁵ Shoup, *supra* note 2, at 33.

sophistication not only of the benefits of generation-skipping arrangements but also how to draft the instruments to achieve the desired result.⁶

The combination of these circumstances does not necessarily lead to the conclusion that more generation-skipping than indicated by the empirical data existed prior to the Tax Reform Act of 1976. It does, however, permit the observation that the technique probably became more widely known. In any event, if the testimony before Congress of acknowledge estate planning experts⁷ is at all representative it is probable that its use by wealthier taxpayers was at least as extensive after the date of the survey (1959) as before.

7. *Summary.*—Untaxed generation-skipping transfers have the potential seriously to erode the tax base. The problem is greatest in generation-skipping transfers that skip the generation immediately below the initial transferor of property. Existing data demonstrate that taxpayers do utilize generation-skipping arrangements and that the use of those arrangements is principally by wealthy taxpayers. As a result, this self-selected group of taxpayers has been able to effect a reduction of the tax burden borne by their wealth transmissions when compared to the burden borne by wealth transmitted by that group of taxpayers who, for whatever reason, did not take advantage of this opportunity. Thus, the horizontal equity criterion is violated. Moreover, those who use generation-skipping transfers are able to reduce the effective rate of tax on their aggregate transfers to a point approaching the burden borne by taxable intergenerational transfers of less wealthy taxpayers. Put differently, wealthier taxpayers are, through generation-skipping, reducing their aggregate effective rate of tax to that nominally applicable to wealth transmissions of considerably lesser amounts. Thus, the vertical equity of the transfers tax system is also affected.

The tax advantages that attach to generation-skipping transfers create a bias in favor of dispositions in trust. This effect violates the principle that the tax system should be neutral with respect to the form of disposition of property.

Finally, the existing data yield one other fact that is significant in assessing the extent of this problem. Single generation-skipping transfers constituted the bulk of generation-skipping dispositions. Since the first generation skip is the major base eroding transfer, this data indicates that solutions to the problem should focus initially on transfers that skip a single generation.

CONGRESSIONAL RECOGNITION OF THE GENERATION-SKIPPING PROBLEM AND AN ANALYSIS OF THE 1976 LEGISLATION

The problems created by generation-skipping transfers were discussed before this Committee in detail in 1973 and 1975.⁸ In 1976, Congress enacted Chapter 13, The Tax on Certain Generation-Skipping Transfers. In acting to eliminate the tax advantages available through generation-skipping transfers, this Committee stated that the new tax was necessary: (a) to assure that the transfer tax applies to taxpayers as nearly as possible on a uniform, generation by generation basis, (b) to reduce the relative tax advantages that generation-skipping afforded to wealthier families, (c) to restore progressivity to the process of wealth transmission, and (d) to restore neutrality in the tax treatment of wealth transfers so that there would be no tax advantage in setting up trusts.⁹

Since its enactment, Chapter 13 has been highly criticized. While there is no question in my mind that Chapter 13 is a superb job of legislative drafting, most agree that the tax has proved administratively unworkable. Some believe it does not go far enough in eliminating the tax advantages created by generation-skipping transfers; others assert it has created its own set of inequities and incentives.¹⁰ I shall

⁶ As just one example, since 1968 the Practising Law Institute has conducted 139 seminars on estate planning and estate administration at various locations around the country.

⁷ See, e.g., General Tax Reform: Panel Discussions Before House Ways and Means Comm., 93d Cong., 2d Sess. (1973) reprinted in Staff of Comm. on Ways and Means, *Background Materials on Federal Estate and Gift Taxation*, 94th Cong., 2d Sess. 69-182 (Comm. Print 1976); Federal Estate and Gift Taxes: Hearings Before House Ways and Means Comm., 94th Cong., 2d Sess. 1332-1447 (1976). See also, G. Cooper, *A Voluntary Tax?* 56-58 (Brookings 1979).

⁸ See, General Tax Reform: Panel Discussions Before House Comm. on Ways and Means, 93d Cong., 2d Sess. reprinted in Staff of Comm. on Ways and Means, *Background Materials on Federal Estate and Gift Taxation*, 94th Cong., 2d Sess. 69-182 (Comm. Print 1976); Federal Estate and Gift Taxes: Hearing Before House Comm. on Ways and Means, 94th Cong., 2d Sess. 1332-1447 (1976).

⁹ House Comm. on Ways and Means Report, The Estate and Gift Tax Reform Act of 1976, H. Rep. No. 94-1380, 94th Cong. 2d Sess. 46-47 (1976).

¹⁰ See generally, Additional Estate and Gift Tax Issues: Hearings Before the Sen. Fin. Subcomm. on Estate and Gift Taxation, 97th Cong., 1st Sess. 37-53, 111-281 (1981).

summarize these criticisms, as they provide the contract for evaluating the two bills before the Committee today.

1. Equity.—Direct, generation-skipping transfers are not subject to Chapter 13. Thus, the most wealthy taxpayers can avoid the tax by making direct generation-skipping transfers, either outright or to a trust in which there is no intervening generation with a present interest or power ("layering" dispositions). One purpose of the enactment of Chapter 13 was to reduce the relative advantage that wealthy individuals, who could afford to make dispositions in trust, had over those who did not have sufficient resources to make trust dispositions. The effect of Chapter 13 is perpetuate this tax advantage for the "super wealthy" to the disadvantage of those who, while able to make trust dispositions, do not have sufficient wealth to engage in "layering" dispositions.

Apart from the bias accorded those who can afford to "layer" their dispositions, Chapter 13 contains a number of elements that favor those who make trust dispositions in which interests are split between generations over those who do not. The "grandchild exclusion" permit tax-free single generation skips for those who would be subject to tax if the property passed outright from generation to generation. The exception for powers to appoint among lineal descendants of the grantor permits members of intervening generations to direct the ultimate disposition of property placed in trust without the imposition of the tax. The current income exception likewise permits trust property to be distributed in a tax-free generation-skipping transfer.

Thus the structure of Chapter 13 does not conform precisely to the legislative purpose of assuring the taxation of property once a generation. Moreover, these avoidance techniques have been widely noted at seminars and continuing legal education programs with the results that many practitioners have become aware of their existence and have at least been instructed in how to draft instruments to utilize them effectively.

2. Neutrality.—Chapter 13 does not remove differences in tax treatment attributable solely to the form of the disposition. First, outright transfers are treated differently than transfers to generation-skipping trusts. Second, transfers in trust are not subject to Chapter 13 if no intervening generation has a present in or power over the trust. Tax minimizing transferors are induced to tailor their dispositions to achieve tax exempt status despite the fact that they might otherwise desire the flexibility of a discretionary family trust for non-tax reasons.

3. Administrability.—Chapter 13 has created administrative problems at a number of levels.

(a) Statutory complexity.—Chapter 13 seeks to replicate the treatment of outright intergenerational property dispositions, but only if, on a "wait and see" basis, a generation-skipping transfer (as defined) actually occurs. This goal of precision—taxing only transfers that are generation-skipping (as that term is defined) at the time such transfers occur and at a rate determined by reference to the transfer tax profile of an appropriate individual in the intervening generation—is, of course, desirable. However, the statutory structure necessary to accomplish this goal is complex. Rules are required to define the time at which a generation-skipping transfer occurs and to identify the individual (the "deemed transferor") whose transfer tax profile is to be used to determine the amount of tax due.

A second layer to statutory complexity is added once the decision is made to exempt certain types of generation-skipping transfers from the ambit of the tax. If outright generation-skipping transfers are exempted from the tax, it is claimed that direct transfers in trust in which no intervening generation has an interest or power should likewise be exempt. Thus rules must be devised to determine the circumstances under which intervening generations will be treated as having a sufficient interest in the trust to have it treated as a generation-skipping trust. A line must be drawn somewhere and once it is accepted that the intervening generation may participate in the administration of the trust without triggering generation-skipping transfer consequences, it becomes very difficult to draw a line that is both simple to administer and defensible on policy grounds. Indeed, one need only look to the legislative history of the tax treatment of powers of appointment under the estate and gift tax to be reminded of the difficulty of establishing this line and the complexity that results once artificial distinctions are made in the name of preserving flexibility.

Complexity also arises due to the need to define the parameters of other exclusions. Rules are necessary to define and limit the scope of both the grandchild exclusion and the current income exception.

(b) Administration and compliance. Chapter 13 also raises difficult problems of administration and compliance from the viewpoint of both taxpayers and the Internal

Revenue Service. Chapter 13 has been in effect for eight years. No final regulations have been promulgated, nor was a return finalized until June of 1982. In this atmosphere, it is difficult for practitioners to anticipate correctly the impact of the tax. Obviously, they have also been unable to comply with the nominal reporting requirements. While the problems of inadequate administrative guidance may be cured over time, significant costs are incurred in the interim. Moreover, even if the rules of the game are clarified, it is unlikely as a practical matter that either taxpayers or the Service will have the information necessary to assure accurate filing and audit of generation-skipping tax returns. The need to identify a "deemed transferor" and quantify his transfer tax base creates significant administrative problems in addition to those which arise simply due to the lack of interpretative guidance.

4. *Summary.*—It is fair to say that the experience under Chapter 13 has been unsatisfactory. While the statute reduces the tax advantage of generation-skipping transfers for many taxpayers, it leaves open avoidance opportunities for others, thus raising equity and neutrality concerns. Moreover, its complexity gives rise to serious interpretative, administrative and compliance problems which raise transactions costs to a level viewed by many as unacceptable.

THE ALI DISCUSSION DRAFT—H.R. 6261

Having reconfirmed the conclusion that generation-skipping transfers needed to be covered by the wealth transfer tax and having in mind the criticisms leveled at Chapter 13, Joseph Karbiganer, and I, in conjunction with our consultants and the ALI Tax Advisory Group sought to develop proposals to subject generation-skipping transfers to a neutral and administrable taxing regime. In so doing we were well aware that a complex solution to an acknowledged problem may ultimately prove more costly than doing nothing. Accordingly, we attempted to devise a statutory structure based on familiar estate and gift tax concepts while avoiding undue administrative difficulties. The proposals sacrifice precision to some extent. However, this is a worthwhile trade if the result is, as I believe it is, a statute that avoids the problems of Chapter 13.

The technical details of the operation of the structure reflected by H.R. 6261 are set out in the ALI Discussion Draft at pages 21 through 61. I shall not repeat them here. I do, however, want to emphasize my belief that the system of taxation envisioned by H.R. 6261 is relatively simple.

Under H.R. 6261 all trusts are classified into two categories, Non-Owned Trusts and Owned Trusts. Any distribution from a Non-Owned Trust to a beneficiary who is not assigned to a higher, the same or next lower generation as the grantor (the "Excepted Class") is treated as a gift made by the trust. A tentative tax is computed by multiplying the amount of the gift (reduced by a specified percentage of the distribution that constitutes taxable income to the beneficiary) by the maximum federal transfer tax rate. The tentative tax is offset by a \$417,000 generation-skipping tax credit (the "GST credit"). To prevent undue deferral of the generation-skipping tax, long term trusts are deemed to terminate periodically. When a termination occurs, an estate tax is imposed on the trust.

If a trust is an Owned Trust, the beneficiary of the trust is treated as the owner of the trust property and dispositions of trust property are included in the transfer tax base of the beneficiary. In general, a beneficiary is treated as the owner of the trust property if the trust property (or a separate share) is available to the beneficiary during his lifetime and cannot be diverted to anyone else without his consent.

Approximate neutrality between outright generation-skipping transfers and generation-skipping transfers made by a Non-Owned Trust is achieved by imposing upon outright skips a surtax that reproduces the tax burden that would have been imposed had the transferor first made a transfer to a Non-Owned Trust and the Non-Owned Trust then transferred the property to the ultimate recipient.

The application of the Non-Owned Trust rules can be illustrated by an example involving a common form of trust, a testamentary discretionary trust for the benefit of the spouse and issue of a decedent. Distributions to grandchildren of the decedent will be subject to tax. The tentative tax on a distribution made in 1988 would be .5 times the amount of the distribution (reduced by a percentage of the distribution that constituted taxable income to the grandchild). Any unused portion of the decedent's \$417,000 GST credit will be used to offset the tax.

To summarize, in order to determine the tax consequences of a distribution from a Non-Owned Trust it is necessary to know only four things: (1) the identity and generation assignment of the distributee, (2) the amount of the distribution, (3) the amount of the distribution that constituted taxable income to the beneficiary, and (4) the remaining amount of the grantor's GST credit. If, as is likely to be the case,

the grantor has not created any other Non-Owned Trusts, the trustee will possess all the relevant information and can easily compute the tax.

The surtax on an outright skip is equally simple to compute. If the outright skip is a testamentary gift the tentative amount of the surtax is the amount of generation skipping tax that would have been imposed on the amount transferred if the amount had been distributed from a Non-Owned Trust. The decedent's remaining GST credit is then used to offset the tentative tax liability. If the outright skip is an inter vivos gift, the amount of the surtax is computed by adding to the tentative tax determined above the amount of the gift tax that would have been imposed by Chapter 12 if the amount of the outright skip had included the generation-skipping tax payable on account of the outright skip. To illustrate, if a decedent makes a bequest \$1,000,000 in 1988 outright to a grandchild the tentative surtax is \$500,000. If the decedent's entire GST credit is available, the actual surtax will be \$83,000. If the transfer is made prior to death by the same individual who is in a 50 percent transfer tax bracket and has not used any of his GST credit, the tentative surtax is \$500,000 plus \$41,500 or \$541,500. The actual surtax, after the use of transferor's GST credit, is \$124,500.

In summary, in order to compute the surtax on a testamentary outright skip the fiduciary needs to know only two things: (1) the amount transferred, and (2) the amount of the decedent's GST credit to be allocated to the surtax. The fiduciary will normally have this information in hand. If the transfer occurs inter vivos the transferor needs to know one additional fact—his own marginal transfer tax bracket.

I would like to make several points about this structure. First, all Non-Owned Trusts are treated similarly. A generation-skipping tax is payable only when a distribution is made to a beneficiary who is not in the Excepted Class. Second, the tax base for all taxable distributions is the same; the distribution is treated as a taxable gift. Third, except for long term trusts, the need to identify who possesses interests in a trust is eliminated. Fourth, since all trust distributions to beneficiaries who are not members of the Excepted Class are taxable, the surtax is applied only to outright generation-skipping tax is imposed at the time of the initial transfer is narrowly confined. Fifth, the Owned Trusts concept enables transferors to create separate trusts for the benefit of particular individuals. As non-family members are not included in the Excepted Class, distributions from a Non-Owned Trust to such individuals will be taxable distributions. This result can be avoided, however, by the creation of an Owned Trust for a non-family member. Sixth, since the Owned Trust definition includes QTIP trusts, sections 2519 and 2044 are no longer necessary. Finally, the combination of the Non-Owned and Owned Trust rules permits the repeal of the power of appointment provisions of the estate and gift tax. The Owned Trust rules treat the holder of an absolute, non-lapsing, right to withdraw corpus as the owner of the trust property. In all other cases, the Non-Owned Trust rules provide for appropriate transfer taxation of property subject to a power of appointment.

SPECIFIC POLICY ISSUES

Before discussing the differences between H.R. 6260 and H.R. 6261 I would like to emphasize that the thrust of both bills is the same and many fundamental policy questions are resolved in a substantively identical matter. Indeed, the bills are distinguished more by their conceptual similarities than their differences. For example, both eliminate computational complexity by subjecting generation-skipping transfers to a flat tax rate, thereby eliminating the need to identify an individual whose tax profile is used to determine the generation-skipping tax. Both bills include distributions of income and principal in the tax base. Both exempt distributions in payment of medical or tuition expenses of beneficiaries. Both impose a single generation-skipping tax no matter how many generations are skipped by the transfer. And, most importantly, both contain provisions to bring direct or outright skips (transfers in which no member of an intervening generation possesses an interest in or power over the transferred property) within the ambit of the tax.

1. Direct skips.—I am sure the Committee will hear today from witnesses who will assert that imposing a surtax on direct skips is revolutionary in concept, was rejected by Congress when suggested in 1976 and is theoretically inconsistent with tax imposed on transfers. The concept is not new. The 1969 Treasury Reform Studies and Proposals contained a similar proposal. Moreover, the alleged rejection of the second eight years ago should not deter consideration today in light of experience under Chapter 13 and the equity and neutrality gains that would be achieved. Finally, the argument that an additional tax on direct skips is inconsistent with the theory of a tax imposed on transfers, while superficially appealing, may too simplistic a way of viewing the problem.

One purpose of the generation-skipping tax is to assure periodic imposition of the transfer tax no matter what form the disposition takes. The goal is to assure that a transfer of property to a beneficiary in a remote generation bears approximately the same burden as that which would have occurred had the property actually passed through the tax base of a member of each intervening generation. If one assumes that a tax will be imposed on generation-skipping transfers in which a member of an intervening generation possesses an interest in or power over the transferred property, the failure to tax direct skips results in incomplete coverage. It creates a distinction between those who transfer property directly to beneficiaries more from generation below them and those who do not. Moreover, it violates the neutrality principle because the lower tax burden will induce direct skips as opposed to other dispositions. Thus, I believe that the taxation of direct skips is essential to assure a fair and neutral generation-skipping tax.

2. Multiple generation skips.—Both bills impose a single tax no matter how many generations have been skipped by the transfer. As the Committee has noted, this feature of the bills is inconsistent with the notion that a tax should be imposed in a manner that approximates the result that would have occurred had the property actually passed through each intervening generation. It is also true that failure to impose an additional generation-skipping tax on multiple generation skips provides a tax preference for those with wealth sufficient to make such transfers.

This problem was considered in developing the proposals contained in H.R. 6261. We concluded at the time that an additional tax on multi-generational skips would result in unnecessary complication. First, as has been noted earlier, the first generation skip creates the largest equity and neutrality problem. Second, existing empirical evidence suggests that very little property is transferred in a way that skips more than one generation. Finally, we did not believe that many direct double generation skips actually occur. To accomplish that result, an individual would have to create an Owned Trust or make an outright transfer to greater grandchildren, a disposition that, in our experience does not happen often.

However, on reflection, I am concerned that if a tax preference is given to multiple generation-skips the most wealthy class of grantors will create Non-Owned Trusts for the benefit of remote generations. Thus, I would have no objection to a provision imposing an additional tax on such transfers, provided the provision is not unduly complex.

Despite their similarities, the bills do differ in their approach to a number of specific issues upon which the Committee has requested comment. The most important of these is the method adopted to limit the application of the tax.

1. Limiting the application of the tax.—H.R. 6260 provides a transferable \$1,000,000 exemption. H.R. 6261 provides a non-transferable \$417,000 tax credit. These differing approaches raise three questions. First, is an exemption preferable to a credit as a way of limiting the impact of the tax? Second, are the dollar amounts appropriate? Third, should one spouse be able to transfer his or her individual exemption or credit to the other?

(a) Exemption v. credit.—It is easy to see why some should prefer to limit the scope of the tax through an exemption. A trust containing only exempt property would never have to keep any records relating to the tax. At a \$1,000,000 level (or \$2,000,000 or more depending upon the number of spousal aggregations involved) most taxpayers could ignore the tax for estate planning. Due to the limited application of the tax, opponents could not plausibly argue against enactment on the ground of practitioner inability to cope with its intricacies. Finally, the Treasury would be relieved of the burden of monitoring, and providing the information necessary for the administration of, the tax in the vast majority of trusts.

However, an exemption is costly. The effect of the exemption is to remove from the reach of the law, subject only to the limitations imposed by the applicable rule against perpetuities, not only the \$1,000,000 exempt amount but also any appreciation that occurs after the exemption is claimed with respect to the transferred property. Thus, to achieve simplicity, H.R. 6260 abandons the notion of periodic imposition of tax with respect not only to the exempt amount but also its growth.

One can also reasonably predict a number of other unsatisfactory consequences. First, the tax is likely to be ignored by many lawyers. Second, there will be a significant psychological push to use trusts to take advantage of any available exemption. The frequency of "grandchildren exclusion" trusts in post-1976 wills indicate that individuals will create trusts to take advantage of "benefits," even though prior to the enactment of Chapter 13 they did not take advantage of unlimited generation-skipping opportunities. Third, there will be a great temptation to undervalue assets passing to generation-skipping trusts in order to keep them within the exemption. Fourth, the Internal Revenue Service will have no opportunity to audit the values

assigned to assets transferred to exempt trusts since, by definition, the assets will not again be subject to the transfer tax system until after the trust terminates, the property passes to an individual, and that individual makes a gift or dies.

Limiting the application of the tax by way of a credit eliminates these costs and uncertainties. While a tax credit means that no trust has absolute assurance that the tax will never apply to it, it is also clear as an empirical matter that many trusts will never be affected by the tax. It is true that practitioners will have to be aware of the existence of the tax. However, H.R. 6261 was designed to have as little effect as possible on dispositive decisions. To the extent it is successful in achieving this goal, its real effect on practitioners arises only in requiring that they know the time that the tax will be imposed and, at that time, how to compute the tax.

It is also true that under H.R. 6261 someone will have to keep track of the remaining amount of an individual's GST credit and, after the individual's death, the credit must be allocated among the generation-skipping trusts the decedent has created. These are not, however, especially difficult problems—particularly if one is realistic about the sophistication of the taxpayers (or their advisors) likely to be affected by the tax. During the individual's life, he or she can monitor the amount of the credit. At death, the individual may direct the allocation of the credit. If the individual fails to direct an allocation, the bill provides an automatic allocation. And, in any event, the trustees of one affected trust may transfer to another trust the credit allocated, the bill provides an automatic allocation. And, in any event, the trustees of one affected trust may transfer to another trust the credit allocated to it under either of the preceding alternatives. Thus, the need to monitor and allocate the credit does not appear to introduce complications sufficient to lead one to reject the credit approach in favor of the blunt exemption instrument.

(b) Amount of exemption of credit.—The level at which the tax is to apply is a decision the Committee must make after taking in account data on wealthier distribution the Treasury could supply. Thus, it would seem appropriate to inquire how many taxpayers would be affected by the tax at various specified exemption or credit levels.

There is no particular magic to the \$417,000 figure in H.R. 6261. It is simply the value of one run up the transfer tax rate schedule plus one additional unified credit determined after all future changes in the estate tax rate schedule and unified credit are fully phased in. At that time, the credit will permit an individual to make \$834,000 of generation-skipping transfers before the tax applies. It is for the Committee to decide whether this is an appropriate amount.

(c) Transferability between spouses.—The GST credit provided by H.R. 6261 may not be transferred between spouses. The estate and gift tax treats spouses as separate transfer tax taxpayers despite the fact that most inter-spousal transfers are now tax-free. In the estate tax, the unused credit of one spouse is not available to offset deathtime transfers made by the other. I recognize that spouses can fully utilize the credits of both through planned tax-free interspousal transfers followed by transfers to trusts by the donee spouse. However, until the spousal unit is treated as a separate taxpaying unit for all purposes of the transfer tax, it does not seem appropriate to create an automatic spousal GST credit of \$834,000.

2. Annual present interest exclusion.—H.R. 6260 permits a \$10,000 annual exclusion under the circumstances specified in section 2625. H.R. 6261 does not allow a \$10,000 exclusion.

The \$10,000 present interest exclusion was originally enacted for administrative reasons, to eliminate the need for individual transferors to account for gifts of small amounts or value. Since trustees have to account, as a non-tax matter, for all distributions, the justification for the exclusion is inapplicable to trusts.

Moreover, the allowance of a \$10,000 exclusion for annual distributions to each beneficiary would create tax pressures to distribute property and could also result in a significant erosion of the tax base. Attempts to limit the availability of the exclusion lead to complex statutory provisions (as illustrated by section 2625 of H.R. 6260) and increase administrative costs.

Under H.R. 6260, draftsmen may be tempted to achieve the substantive equivalence of allowing the present interest exclusion by directing the distribution of up to \$10,000 annually to members of the excepted Class in the hope that those transferees will subsequently transfer that amount to younger generation beneficiaries. However, I do not believe that possibility is sufficient to outweigh the conceptual and administrative objections to the allowance of the exclusion.

3. Credit for State taxes.—H.R. 6260 provides a credit for state generation-skipping taxes if the conditions specified in section 2604(a) are met. H.R. 6261 does not have a comparable provision.

As the Committee has recognized, the question whether a credit for taxes paid to a state is to be allowed is essentially a revenue sharing question. If the credit is allowed, dollars that would otherwise go to the U.S. Treasury go instead to the states that impose a creditable tax.

From a tax standpoint, the issue raised by the allowance of a credit is that of additional statutory and administrative complexity. I have no strong feelings on this question apart from my fundamental disposition toward simple tax structures.

4. *The tax base, tax rates and the time the tax is imposed.*—H.R. 6260 adopts a tax inclusive (estate tax) base for taxable distributions and taxable terminations. The tax base for direct skips is a tax exclusive (gift tax) base. The transferor (or trustee) pays the tax in the case of a taxable termination or direct skip. The transferee pays the tax in the case of a taxable distribution. A direct skip is defined as an outright generation-skipping transfer or a transfer to a trust in which no member of the generation below that of the transferor has an interest or power. The tax on a direct skip is due when the transfer is made (whether outright or in trust).

Under H.R. 6261 the transferor (or trustee) pays the tax in all cases. The tax is calculated by reference to a tax exclusive (gift tax) base unless the taxable event is a taxable termination. However, even in the latter case, H.R. 6261 permits distributions made within nine months of a taxable termination to be taxed on a tax exclusive basis. With respect to all trust transfers, the tax is paid only when a taxable distribution (or termination) occurs. Generation-skipping tax is imposed on the initial transfer only if the transfer is an outright skip.

If the tax base is tax exclusive, the tax rates necessary to raise a given amount of revenue must be higher than those imposed on a tax inclusive base simply because the tax exclusive base is smaller. The effect of adopting a tax exclusive base in most cases under H.R. 6261 is to reduce the tax rate, when measured on a tax inclusive basis, from 50 percent (in 1988) to 33⅓ percent. The tax inclusive tax rate under H.R. 6260 is (in 1988) 40 percent.

Obviously, it would be preferable to have a uniform tax base, stated either as a tax inclusive (estate tax) or tax exclusive (gift tax) amount. However, since the base is presently different for the estate and gift taxes, the generation-skipping tax must resolve this inconsistency. H.R. 6261 reflects the judgment that a base that is as uniform as possible is to be preferred. The reasons for this judgment may be illustrated by analyzing the effects of H.R. 6260.

Under H.R. 6260 there is a rate differential that depends upon whether the skip is direct or through a generation-skipping trust. A lower tax is imposed on direct skips, but the lower tax is due at the time of the initial transfer. In practice this means that financial decisions will have to be made early in the planning or administration process and these decisions will be influenced in part by the tax structure.

For example, although it is probably demonstrable that it is economically more desirable to pay a transfer tax at a lower rate today than at a higher rate in the future (no matter how far in the future or how much the deferred tax dollars earn or grow), few if any lawyers or clients will be able both to comprehend and accept the arithmetic. For those who do not accept the desirability of early payment at a low rate, natural inclinations to pass property beyond the next lower generation will be put aside and attempts will be made to defer the tax as long as possible (probably through the creation of trusts with nominal beneficiaries chosen primarily for their generation assignment). For those who accept the arithmetic but, for whatever reason, want to use a trust as the transfer vehicle, drafting and planning complexities will be generated by the need to insure that no beneficiary in the intermediate generation will have an interest.

I believe that these considerations, as well as predictable administrative problems arising from the need to determine whether a member of an intervening generation possesses an interest in or power over a trust, are largely mooted by the structure adopted in H.R. 6261. Under H.R. 6261 the nature and timing of the tax turns only the identity and generation assignment of the recipient. The form of the trust is irrelevant.

CONCLUSION

The two bills before the Committee today represent sound starting points for a revised generation-skipping tax. I believe that the credit mechanism of H.R. 6261 when combined with the taxation of all trust distributions when made to younger generation beneficiaries is a superior way to tax generation-skipping transfers. However, if a credit rather than an exemption were adopted, the approach of H.R. 6260 would also be acceptable.

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The American Law Institute

FEDERAL ESTATE AND GIFT TAX PROJECT STUDY ON GENERATION-SKIPPING TRANSFERS UNDER THE FEDERAL ESTATE TAX

Discussion Draft No. 1

(March 28, 1984) -

SUBJECTS COVERED:

Introduction:

Part I. Summary of Principal Recommendations

Part II. Detailed Explanation of Principal Recommendations

Part III. Commentary on Reporters' Recommendations

Submitted by the Council to the Members of The American Law
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Federal Estate and Gift Tax Project

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Foreword

In April, 1982, a distinguished group of tax specialists, invited to identify areas of federal taxation in which the Institute could most usefully do further work, accorded high priority to the treatment of generation-skipping transfers. The subject had been addressed in the Tax Reform Act of 1976, enacting Chapter 13 of the Internal Revenue Code, with results widely considered unacceptable both in theory and in practical administration (see pp. 176-183, *infra*), generating a strong movement for repeal. The Advisers considered, however, that some control of tax avoidance through the medium of skipping transfers was essential to protect the integrity of the entire system. They urged, therefore, that the Institute explore the question whether the statute could be revised to provide a solution of the generation-skipping problem that would be sound in its conception of tax policy and viable in practice.

The Council was responsive to the challenge, the more so since the Institute in 1968 had recommended that an additional tax be levied on some generation-skipping transfers, a proposal that was not without its influence in the development and the enactment of the present law. See pp. 160-176, *infra*. The Reporters began work in January, 1983, and with the active assistance of the Consultants and the Tax Advisory Group developed the conclusions and proposals now presented in this Draft.

Shortly after the Reporters started work on these problems, the Treasury came forward with a generation-skipping tax proposal, designed to replace entirely the present Chapter 13, a proposal that is in some respects still in process of development. See pp. 187-199, *infra*. The differences between the conclusions and recommendations of the Reporters and the latest Treasury proposals (see pp. 200-206, *infra*) merit close consideration. Their differences are less important, however, than their common ground: (1) that generation-skipping transfers are a problem that requires special statutory treatment in a system of estate gift and gift taxation; and (2) that it is possible to formulate a statutory solution that is just and viable. Those who share these premises should find this Draft of great assistance in appraising the details.

The Draft, it should be added, had substantial support from the Consultants and the Tax Advisory Group. It was presented to the Council in February, 1984, when sufficient time was not available for full consideration, not to speak of reaching a conclusion on the merits. The Council decided, therefore, to go no further than to authorize the publication of the Study and its submission to the Institute only for preliminary discussion, postponing any effort to reach a determination on the merits to future meetings of the Council and the members. It was envisaged, however, that the distribution of the Draft might be of aid in the legislative process as an expression of the views of the Reporters, the Consultants and the Tax Advisory Group, whose professional credentials need no exposition here.

Subsequent to the meeting of the Council, the Senate Finance Committee recommended the repeal of Chapter 13. The Ways and Means Committee of the House of Representatives has not, however, so far as we know, thus far addressed the question. If by the time of the Institute meeting, Congress has taken action that renders the issue moot, it may be decided to forgo discussion of the Draft. If, on the other hand, the issue is still open, its discussion may be very useful.

Whatever the future may portend, this Draft is an important contribution to the understanding and solution of a problem that will be with us as long as a tax on transfers *inter vivos* or by will endures.

HERBERT WECHSLER
Director
The American Law Institute

March 28, 1984

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Preface

The Study on Generation-Skipping Transfers began in January, 1983. It was commissioned against the background of mounting dissatisfaction with, and calls for the repeal of, the tax on certain generation-skipping transfers (Chapter 13 of the Internal Revenue Code) that had been enacted as part of the Tax Reform Act of 1976. The Study was to take a fresh, objective look at the question whether, viewed solely in the context of the existing estate and gift taxes (Chapters 11 and 12 of the Internal Revenue Code), untaxed generation-skipping transfers caused a problem when analyzed in light of the equity, efficiency and administrability criteria usually associated with a "good" tax system. Put a little differently, the question was whether the coverage accorded wealth transfers under the estate and gift tax was sufficiently comprehensive. If this examination revealed the existence of a problem or a gap in coverage, the Reporters were to propose solutions consistent with a tax imposed on wealth transfers. Alternative systems of wealth taxation, such as an accessions tax, were not to be considered.

The Reporters have met twice with their Consultants and once with the Tax Advisory Group. After an independent study of the issues, the Reporters, Consultants and Tax Advisory Group have concluded that untaxed generation-skipping transfers are a transfer tax problem and should be subject to tax. This is significant. It reconfirms the

conclusions underlying the 1968 American Law Institute Federal Estate and Gift Tax Recommendations, the 1969 Treasury Department Tax Reform Studies and Proposals and the 1976 Congressional findings with respect to the need to tax generation-skipping transfers. It also reinforces the view of the current Treasury Department that the repeal of the present tax on generation-skipping transfers is acceptable only if an effective and administrable alternative is enacted in its place.

As a result of this conclusion, the Reporters, with the assistance of their Consultants and the Tax Advisory Group, developed proposals to subject generation-skipping transfers to a neutral and administrable taxing regime. This, too, is significant. The level of dissatisfaction with current law¹ illustrates the fact that a complex cure to an acknowledged problem may ultimately be worse than doing nothing. The Reporters believe their proposals avoid this pitfall.

The Reporters' study of the question whether generation-skipping transfers cause a problem is contained in the first three Appendices of this draft. As background, for those interested, the Reporters suggest that the material at pages 105-123 in particular be reviewed.

After this Project began, the Treasury Department released proposals to replace Chapter 13. The Reporters view the Treasury Proposals, which are in the process of ongoing modification, as more administrable and neutral than

¹See pages 176-184.

current law. However, the Reporters believe their proposals are superior in a number of major respects. The Treasury Generation-Skipping Tax Proposal is included as Appendix D. An analysis of some of the major differences between it and the Reporters' proposals follows the Treasury description.

The text of this Discussion Draft is organized as follows. The Introduction summarizes the current state of the Study. The Reporters' recommendations are set forth in Part I. Part II is a detailed explanation of these recommendations. Part III is a commentary on the recommendations, containing a discussion of alternatives the Reporters considered and rejected.

Introduction

Background

There are three generic types of generation-skipping transfers. The first is a transfer, in trust or otherwise, pursuant to which a person, who is a member of a generation below that of the transferor and above that of the ultimate recipient of transferred property, possesses some form of economic interest in the transferred property but not an interest sufficient to cause inclusion in his transfer tax base of the property in which he has an interest. The economic interest may be fixed; for example, a transfer by a father of property in trust to pay the income to his son for life, remainder to his grandson. Alternatively, receipt of the benefit may be in the discretion of a third party; for example, a transfer in trust to a third party trustee with unfettered discretion to pay or accumulate income and/or principal for the benefit of the grantor's child for life, remainder to grandchildren.

The second is a transfer, in trust or otherwise, pursuant to which a person other than the transferor, who is a member of a generation below the transferor, has the power to direct the economic benefits of the transferred property to others, who may be members of a generation below the power-holder, but cannot himself benefit economically from the exercise of the power. A typical disposition of this type is a transfer to a child as trustee to distribute, in his discretion, income and/or corpus to the grandchildren of

the grantor until the youngest grandchild attains a fixed age, with distribution of the remaining trust corpus to the grandchildren at that time.

The first and second types of transfers may be combined so that a person possesses both an economic interest in the transferred property and a special power to identify the ultimate takers of the transferred property. A typical disposition of this type is a transfer of property in trust to pay the income to the grantor's child for life, remainder to such others as the child shall select.

The combination of non-taxable interests in and powers over transferred property can come very close to the substantive equivalent of outright ownership. An individual may possess the following interests in and powers over the transferred property without causing the property to be included in his or her transfer tax base: "(1) the right to receive the income from the trust; (2) the power to invade the principal of the trust, if this power [is] subject to an ascertainable standard relating to health, education support, or maintenance; (3) a power . . . to draw down annually from . . . the principal the greater of 5 percent of its value or \$5,000; (4) a power, exercisable during life or by will, to appoint any or all of of . . . the principal to anyone other than [the holder], his creditors, his estate or the creditors of his estate; [and] (5) the right to manage the trust property by serving as

trustee."¹ Transfers that skip generations may skip a single generation or may be used to postpone transfer tax incidence until the expiration of the applicable local law version of the Rule Against Perpetuities.

The third type of generation-skipping transfer is a transfer in which no member of an intervening generation possesses an interest in or power over the transferred property. An outright transfer of property from a grandfather to his grandchild when there is a living child is the paradigm. A transfer by a grantor to his wife as trustee to pay income to a grandchild for a term of years and then to distribute the corpus to the grandchildren when there are living children is another example. Similar examples where the child is dead present a less clear case.

The foregoing illustrates the extent to which generation-skipping transfers may be made under the existing estate and gift tax structure. While the form and duration of the arrangements differ, all share one common characteristic. Ultimate ownership of the transferred property passes to individuals separated from the transferor by an intervening generation at the cost of a single excise levied upon the original transferor at the tax rates applicable to his cumulative transfers at the time of the transfer.

¹Staff of Jt. Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 564 (Jt. Comm. Print 1976). The value of the property subject to an annual "5 and 5" power that has not lapsed at the death of the holder will be included in the holder's gross estate under §2041.

The Reporters examined the consequences of these generation-skipping transfers and concluded that, in theory, their availability raised serious equity and neutrality problems.² Those with sufficient wealth are able to dispose of property in trust in a manner that avoided tax on the expiration of interests in and powers over the transferred property. Those with wealth insufficient to justify use of a trust transfer property outright to individuals with transfer taxation occurring each time a transfer was made. These differences result in horizontal inequity because the aggregate tax burden on the process of wealth transmission differs depending upon the form of the transfer. Vertical inequity also occurs because the effective rate of tax on generation-skipping transfers is less than that on sequential outright transfers. Moreover, the tax advantages that attach to generation-skipping transfers create a bias in favor of dispositions in trust. This effect violates the principle that the tax system should be neutral with respect to the choice of the form of disposition of property.

²The Reporters' statement of the criteria used in analyzing the nature and extent of the problems caused by generation-skipping transfers is set forth in Appendix A.

The Reporters believe, in addition, that the current transfer tax system is insufficiently comprehensive because it permits tax free transfers of property through trusts to beneficiaries in the same, a higher, or next lower generation than the grantor. A majority of the Consultants and the Tax Advisory Group did not share the Reporters' views on this issue. Accordingly, the recommendations contained herein are directed solely at generation-skipping transfers.

Existing empirical data and anecdotal evidence confirmed that these theoretical problems were real.³

The Consultants and the Tax Advisory Group overwhelmingly confirmed the Reporters' conclusions with respect to generation-skipping transfers in trust. They agreed that the opportunity to dispose of property in trust in a manner that avoids tax in an intervening generation when a member of that generation has an interest in or power over the property results in a serious tax avoidance problem and that the problem should be cured.

The Tax Advisory Group, by a 19-8 vote, also indicated that generation-skipping transfers in which no member of an intervening generation possessed an interest in or power over the transferred property ("outright skips") were a problem that should be cured. Those who voted in the majority expressed the view that equity and neutrality considerations require that outright skips be subject to a differential tax rate designed to assure that an outright transfer of property to a beneficiary in a remote generation bears approximately the same tax burden as that which would have occurred had the property actually passed through the tax base of a member of an intervening generation. If one assumes that a transfer tax will be imposed on generation-skipping transfers in which a member of an intervening generation possesses an interest in or power over the

³The Reporters' analysis of the effects of generation-skipping transfers and a summary of existing empirical data is set forth in Appendix A.

transferred property, the failure to tax outright skips creates an equity problem because a tax preference exists for those with wealth sufficient in magnitude to be split in discrete amounts between two generations. A neutrality problem exists because the tax preference induces outright skips as opposed to other forms of disposition.

Those who disagreed asserted that there is no basis in the theory of a tax imposed on transfers to subject a direct transfer to a remote generation to any form of differential tax rate and that there is no rational way to assess a tax based on the identity of an unknown intermediate transferor. Moreover, some also asserted as an empirical matter that the number of outright generation-skipping transfers is so small as to make the issue *de minimis*.

Proposed Solution

Most of the prior work that has been done in the generation-skipping area has focused on the identification of individuals whose tax profiles can sensibly be treated as appropriate measures of the tax to be applied. If it were possible to treat a trust as if it were a partnership, most of the approaches would work perfectly. However, among the qualities that make the trust concept so valuable as a property law device are the lack of clearly defined economic interests and the ease with which interests in trust shift from one beneficiary to another (without the sharply defined break points that would mark similar shifts of partnership interests). Given the inappropriateness of treating a trust

as if it were a partnership, it is not surprising that the attempts to force the trust into that mold have produced results that are at once complex and unsatisfactory.

Therefore, the Reporters decided to explore a new approach. The material that follows is the result of the exploration. The core concept underlying the Reporters' recommendations is the notion that all transfers to trusts (or trust equivalents) are treated as made to an identified person. Subsequent transfers from the trust are treated as made by the identified person. Unless an individual is treated as the owner of the trust, the trust itself (a "Non-Owned Trust") is the identified person and any distribution from the trust to or for the benefit of a beneficiary who is not assigned to a higher, the same, or next lower generation as the grantor is treated as a gift made by the trust. If an individual is treated as the owner of the trust property that individual is treated as the identified person and dispositions of trust property are treated as made by that individual. In general, an individual is treated as the owner of a trust if the trust property (or a separate share) is available to the individual during his lifetime and cannot be diverted to anyone else without his consent.

To protect against the creation of multiple taxpayers, all Non-Owned Trusts created by an individual are, in effect, aggregated. Aggregation is accomplished in the following way. The tax rate applicable to taxable distributions from any Non-Owned Trust is 50 percent (or the maximum marginal tax rate then in effect under the unified transfer

tax rate schedule). Every individual is entitled to allocate among the Non-Owned Trusts created by him a tax credit of \$417,000. The tax due with respect to any taxable distribution is, therefore, 50 percent of the amount of the taxable distribution less the amount of the credit allocated to the trust.

Approximate tax neutrality between outright skips and generation-skipping transfers in trust is achieved by imposing upon outright skips a surtax that reproduces the transfer tax burden that would have been imposed had the transferor first made a transfer to a Non-Owned trust and the Non-Owned trust then transferred the property to the ultimate recipient.

In summary, the recommendations contained herein are directed solely at generation-skipping transfers. The basic components are:

I. Non-Owned Trusts Except where an individual is treated as the owner of a trust (see II, below), all trusts created by a grantor ("Non-Owned Trusts") are considered a single separate transfer tax taxpayer:

A. Taxable distributions, the amount of which will be determined on a "tax exclusive" basis, are taxed to the trust at the maximum marginal transfer tax rate, with a substantial tax credit (the "generation-skipping tax credit").

B. Taxable distributions are transfers from the trust to or for the benefit of a beneficiary who is not

assigned to a higher, the same, or next lower generation as the grantor. However, transfers to charity and in payment of medical or tuition expenses are excluded.

C. A Non-Owned Trust which would otherwise continue, is deemed to terminate periodically (a "taxable termination"), and a tax equivalent to the estate tax is imposed on a "tax-inclusive" basis at the maximum marginal transfer tax rate. The unused portion of the grantor's generation-skipping tax credit is available to offset the tax liability.

II. Owned Trusts Where an individual is treated as the owner of a trust, that person is treated as the owner of the property in the trust for transfer tax purposes (an "Owned Trust").

A. A trust is an Owned Trust when the trust property is available for an individual during his or her lifetime and cannot be diverted to anyone else during his or her lifetime without his or her consent;

B. Transfers to third parties during the lifetime of the owner (which, by definition, require the consent of the owner) are treated as gifts by the owner;

C. At the death of the owner, the trust property is treated as includible in his or her gross estate; and

D. Credits are allowed to insure that, in the usual case, no more than one tax is imposed per generation.

III. Surtax on Outright Skips A surtax is imposed on any outright transfer to an individual (or an Owned Trust owned by an individual) who is not assigned to a higher, the same, or next lower generation as the grantor.

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Part I

Summary of Principal RecommendationsNon-Owned Trusts

1. Unless a trust is an Owned Trust, from and after the earliest time a transfer is complete for gift or estate tax purposes a trust or trust equivalent will be a separate transfer tax taxpayer and a gift tax will be imposed on Taxable Distributions from the trust.

2. A Taxable Distribution is any distribution of income or principal other than a distribution:

- a. to or for the benefit of a beneficiary assigned to a generation or generations higher than, the same as, or not more than one below the Grantor. This class of transferees is called "the Excepted Class";
- b. in payment of medical and tuition expenses of any beneficiary;
- c. to charity; or
- d. from one Non-Owned Trust to another Non-Owned Trust.

3. All Taxable Distributions will be subject to transfer tax at the maximum marginal transfer tax rate in effect at the time the distribution occurs. The amount of a Taxable Distribution will be determined on a tax exclusive (gift tax) basis.

4. A tax credit (the "Generation-Skipping Tax Credit") will be available with respect to Taxable Distributions from all trusts created by an individual Grantor. The credit

will be equal to the difference between (1) the product of the maximum marginal transfer tax rate and the dollar amount of transfers at which that rate first applies and (2) the tax, net of the estate and gift tax unified credit, which would be payable by an individual on account of a transfer of that amount.⁴

- a. The Grantor will be entitled to allocate the unused credit at death as desired. In the event the Grantor fails to make an allocation, the unused credit will be allocated first to any Surtax liability attributable to Outright Skips occurring at the death of the Grantor and then in proportion to the asset value, at the estate tax valuation date, of the trusts subject to this rule. However, if the trustees of any such trusts agree to a different allocation of any unused credit among such trusts, that different allocation will be binding.
- b. The Grantor's Generation-Skipping Tax Credit will remain available as long as a Non-Owned Trust created by the Grantor remains in existence. When a Non-Owned Trust distributes all its assets to an individual or an Owned Trust, any unused credit it possesses after its final Taxable Distribution will be allocated to all other Non-Owned Trusts

⁴Under the rate schedule in effect in 1987, the credit amount is \$417,000.

created by the same Grantor and still in existence. In the absence of a contrary allocation by the trustee of the distributing trust, the unused credit will be allocated pro rata among such trusts on the basis of the fair market value of such trusts at that time.

5. A Non-Owned Trust will be deemed to terminate periodically (a "Taxable Termination") if the trust has beneficiaries assigned to generations below that of the Grantor and those beneficiaries are not members of the Excepted Class, or beneficiaries who are not assigned to generations.

- a. If any trust has beneficiaries assigned to generations below the Grantor and those beneficiaries are not members of the Excepted Class, a Taxable Termination will occur at such time, after the later of the death of the Grantor or the termination of the last interest of the last beneficiary who is a member of the Excepted Class, as the last Interest of the last beneficiary in the highest generation of beneficiaries not included in the trust's Excepted Class terminates.
- b. If a trust has no beneficiary assigned to a generation, a Taxable Termination will occur 35 years from the later of the death of the Grantor or, if the trust at any time had beneficiaries who were assigned to generations, 35 years from the later of the death of the Grantor, the termination

of the last interest of the last beneficiary who was a member of the Excepted Class, or the last prior Taxable Termination, and at 35 year intervals thereafter.

6. When a Taxable Termination occurs, an estate tax at the maximum marginal transfer tax rate then in effect will be imposed upon the entire undistributed trust corpus.

- a. The unused portion of the Generation-Skipping Tax Credit allocated to the trust will be available to offset this tax liability.
- b. Any distribution occurring within nine months after a Taxable Termination will be treated as a Taxable Distribution. The value of the property distributed plus the tax attributable to the distribution will be eliminated from the base used for the computation of the tax on the Taxable Termination.
- c. After a Taxable Termination the amount of the trust's Generation-Skipping Tax Credit will be renewed. The amount of the post-Taxable Termination credit will initially be equal to the amount of the Generation-Skipping Tax Credit originally allocated to the trust increased by the amount of any Generation-Skipping Tax Credit originally allocated to any other Non-Owned Trust created by the same Grantor and transferred to the trust prior to the Taxable Termination, and decreased by

the amount of such credit transferred by such trust to any other trust prior to the Taxable Termination.

- d. After a Taxable Termination, the Excepted Class will include all beneficiaries assigned to the generation that is two generations below that of the youngest generation of beneficiaries included in the Excepted Class prior to the Taxable Termination.

7. The trust will be allowed a transfer tax deduction of [x] percent of the portion of any Taxable Distribution that constitutes taxable income to the recipient.

8. Sections 2514 and 2041, relating to the transfer tax consequences of the possession of powers of appointment, will be repealed.

Owned Trusts

1. From and after the earliest time a transfer is complete for gift or estate tax purposes, a beneficiary will be treated as the Owner of the trust to the extent that

- a. a gift or estate tax marital deduction was allowed for the transfer to the trust, or
- b. if the beneficiary is not the spouse of the Grantor, the beneficiary has an absolute non-lapsing right to withdraw principal or
- c. if the beneficiary is not the spouse of the Grantor,
 - (1) the trustee has the power to pay or apply income to or for the benefit of the beneficiary at any time during the lifetime of the beneficiary, and
 - (2) no distribution may be made to anyone other than the beneficiary during the lifetime of the beneficiary except with the consent of the beneficiary.

2. A beneficiary will be treated as the Owner of a trust only to the extent the interest, if in less than the entire corpus, is described in terms of a fractional share of the trust.

3. Any transfer during the lifetime of the Owner to a third party from that portion of the trust the Owner is treated as owning will be treated as a transfer by the Owner for all purposes of the transfer tax.

- a. The transfer of any part of the income interest owned by the Owner is a transfer of the value of such part. The transfer does not cause the Owner to cease being treated as the Owner of the corpus to which the income interest related. The same rule will apply if the Owner transfers the entire income interest. If, after such a transfer, the Owner possesses no right to receive, or to direct the distribution of, corpus, the Owner may elect, on a timely filed gift tax return, to be deemed to have transferred the remainder interest in the corpus to which the income interest related.
 - b. The termination of a portion of an Owner's interest in the trust is treated as a transfer by the Owner of that portion.
 - c. The Owner will be entitled to reimbursement from the trustee for the amount of the gift tax payable with respect to such a transfer.
4. Where the interest terminates at death, the portion of the trust corpus deemed owned is included in the Owner's gross estate. The Owner's estate will be entitled to reimbursement for the transfer tax attributable to the inclusion of the trust corpus determined on an incremental basis.

5. Nominal Owners will be disregarded.

6. Where the Grantor is in the same generation as or a younger generation than, the Owner, a §2013 type credit would be available upon the termination of the interest of the Owner without a phase out. Where the Grantor is in a higher generation than the Owner or the Owner is not assigned to a generation, the §2013 type credit would be available, but would phase out. For purposes of determining the availability of the credit, the Grantor is the last prior person treated as the Owner of the trust.

7. Except for trusts which qualified for the marital deduction, a Grantor may elect to have an Owned Trust treated as a Non-Owned Trust. The trustee of an Owned Trust created at the death of the Grantor or created by reason of a distribution from a Non-Owned Trust may also elect to have the trust treated as a Non-Owned Trust. Any such election must be made with respect to the entire trust corpus on a transfer tax return timely filed by reference to the date of the first transfer of property to the trust. The election will be irrevocable.

Surtax on Outright Skips

1. A Surtax will be imposed on Outright Skips.
2. An Outright Skip is a taxable gift or transfer at death by an individual or an Owned Trust to:
 - a. an individual assigned to a generation more than one below that of the Grantor, or who is not assigned to a generation and is more than 35 years younger than the Grantor,
 - b. an Owned Trust owned by such an individual, or
 - c. any entity other than a Non-Owned Trust.
3. The amount of the Surtax will be equal to the sum of
 - a. the tax that would have been payable by a Non-Owned Trust created by the Grantor (after reduction for the remaining portion, if any, of the Grantor's Generation-Skipping Tax Credit) had the property been transferred by the Grantor to such trust and immediately distributed to the transferee, and
 - b. in the case of an Outright Skip that is
 - (1) a gift, the amount of the gift tax that would have been payable by the Grantor had the amount of the gift been increased by the amount of tax determined in a., or
 - (2) a transfer at death, the amount of estate tax that would have been attributable to the amount determined in a. had the estate of the Grantor made a net distribution of such amount.

Grantor made a net distribution of such amount.

Part II

Detailed Explanation of Principal RecommendationsNon-Owned Trusts1. Taxation of Distribution From a Non-Owned Trust.

Unless a trust is an Owned Trust, from and after the earliest time a transfer is complete for gift or estate tax purposes a trust or trust equivalent will be a separate transfer tax taxpayer and a gift tax will be imposed on Taxable Distributions from the trust.

Explanation:

In the case of inter vivos transfers, a trust becomes a Non-Owned Trust from and after the time a transfer to the trust or trust equivalent is complete for gift tax purposes. The principles of Reg. §25.2511-2 will be applied to determine when a transfer is complete. However, the Reporters recommend the deletion of the adverse party rule in Reg. §25.2511-2(e). The effect of that change is to render a gift incomplete anytime a donor reserves a power, alone or in conjunction with any other person, to revest beneficial title in himself, to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.

Testamentary trusts are Non-Owned Trusts from and after the time a transfer is made to such trusts.

2. Taxable Distribution. A Taxable Distribution is any distribution of income or principal other than a

distribution:

- a. to or for the benefit of a beneficiary assigned to a generation or generations higher than, the same as, or not more than one below the Grantor. This class of transferees is called "the Excepted Class";
- b. in payment of medical and tuition expenses of any beneficiary;
- c. to charity; or
- d. from one Non-Owned Trust to another Non-Owned Trust.

Explanation:a. Taxable Distributions.

A Taxable Distribution is any distribution of income or principal to the extent it is for less than an adequate consideration in money or money's worth other than a distribution to or for the benefit of members of the Excepted Class (as defined in b. below), in payment of the medical and tuition expenses, as defined in §2503(e), of any beneficiary, or to charity to the extent the distribution would qualify for a charitable deduction under §2522 if made by an individual.

A distribution from one Non-Owned Trust to another Non-Owned Trust is not a Taxable Distribution. If the trusts have not been created by the same Grantor, the tax consequences of subsequent distributions from the trust are determined under the rules relating to Non-Owned Trust with multiple Grantors, discussed at pages 24 and 25.

Distributions to any other entity are Taxable Distributions.

Distributions to individuals who are not members of the Excepted Class or to Owned Trusts owned by such individuals are Taxable Distributions. Thus, for example, if G creates a discretionary trust for the benefit of issue, distributions to G's grandchildren are Taxable Distributions.

No present interest exclusion will be allowed for Taxable Distributions, nor will gift splitting between the Non-Owned Trust and the spouse of the Grantor be permitted.

b. The Excepted Class.

Distributions from a Non-Owned Trust to members of the Excepted Class will not be Taxable Distributions. In general, the Excepted Class with respect to a Non-Owned Trust is any beneficiary assigned to a generation or generations higher than, the same as, or not more than one below the Grantor. The exception to this rule is described at page 35.

An individual is assigned to a generation only if that individual (or a spouse of that individual) is either (a) an ancestor of the Grantor or of a spouse of the Grantor, or (b) descended from a grandparent of the Grantor or of a spouse of the Grantor. For these purposes, a relationship by the half blood is treated as a relationship by the whole blood and a relationship by legal adoption is treated as a relationship by blood. A beneficiary who is not eligible for generation assignment pursuant to the foregoing rules is not a member of the Excepted Class.

An individual who is descended from a grandparent of the Grantor or of a spouse of the Grantor is assigned to the generation determined by counting generations down from the grandparent from whom he or she is descended. An individual who has at any time been married to such an individual is assigned to the same generation as that individual. Thus, if G is married to beneficiary A at the time G creates a Non-Owned Trust, no distributions to A will be Taxable Distributions even if A and G divorce. If G is unmarried, creates a Non-Owned Trust with unrelated party B as a beneficiary and subsequently marries B, distributions to B thereafter will not be Taxable Distributions.

If, under the foregoing rules, an individual is assigned to more than one generation, the individual shall be assigned to lowest such generation. Thus, if G creates a discretionary trust in which G's grandchild GC is a beneficiary and G subsequently adopts GC, GC will continue to be assigned to the second generation below G and will not become a member of the Excepted Class.

Where a trust has multiple Grantors, each Grantor shall be deemed to have created a separate trust. However, the trustee may elect to administer the trust as a single trust. The time at which such an election must be made and the manner of the election will be left to Regulations. If the trustee elects to administer the trust as a single trust, distributions to members of the Excepted Class with respect to any particular Grantor will be excluded in proportion to the value of the contributions made to the trust by that

Grantor divided by the value of all contributions made to the trust. For these purposes, values will be determined at the date a transfer is made to the trust. For example, assume G creates a discretionary trust for the benefit of her grandchildren and, at a time when the trust corpus is \$1,000,000, G's son, S, transfers \$200,000 to the trust. Unless the trustee elects to administer the trust as a single trust, distributions from the trust attributable to G will be Taxable Distributions as G's grandchildren are not members of the Excepted Class; distributions from the trust attributable to S will not be Taxable Distributions as G's grandchildren are members of the Excepted Class determined by reference to S. If the trustee elects to administer the trust as a single trust, 5/6 of each distribution will be a Taxable Distribution.

3. Taxable Distributions Treated As Gifts and Taxed At Maximum Marginal Rate.

All Taxable Distributions will be subject to transfer tax at the maximum marginal transfer tax rate in effect at the time the distribution occurs. The amount of a Taxable Distribution will be determined on a tax exclusive (gift tax) basis.

Explanation:

All Taxable Distributions will be subject to tax at the maximum marginal transfer tax rate in effect at the time of the transfer (subject to a substantial tax credit described in 4. below). Taxable Distributions are treated as gifts. Therefore the tax is imposed on the amount of the distribu-

tion only, and the tax base does not include the tax on the gift. Thus, assuming a 50 percent maximum marginal transfer tax rate, a Taxable Distribution of \$100,000 will result in a tentative tax liability of \$50,000.

In the absence of a contrary provision in the governing instrument or applicable local law, a direction to make a distribution of a stated fraction or percentage of trust principal shall be deemed to be a direction to make a distribution reduced by any tax payable on account of the Taxable Distribution.

4. The Generation-Skipping Tax Credit.

A tax credit (the "Generation-Skipping Tax Credit") will be available with respect to Taxable Distributions from all trusts created by an individual Grantor. The credit will be equal to the difference between (1) the product of the maximum marginal transfer tax rate and the dollar amount of transfers at which that rate first applies and (2) the tax, net of the estate and gift tax unified credit, which would be payable by an individual on account of a transfer of that amount.⁵

- a. The Grantor will be entitled to allocate the unused credit at death as desired. In the event the Grantor fails to make an allocation, the unused credit will be allocated first to any Sur-tax liability attributable to Outright Skips

⁵Under the rate schedule in effect in 1987, the credit amount is \$417,000.

occurring at the death of the Grantor and then in proportion to the asset value, at the estate tax valuation date, of the trusts subject to this rule. However, if the trustees of any such trusts agree to a different allocation of any unused credit among such trusts, that different allocation will be binding.

- b. The Grantor's Generation-Skipping Tax Credit will remain available as long as a Non-Owned Trust created by the Grantor remains in existence. When a Non-Owned Trust distributes all its assets to an individual or an Owned Trust, any unused credit it possesses after its final Taxable Distribution will be allocated to all other Non-Owned Trusts created by the same Grantor and still in existence. In the absence of a contrary allocation by the trustee of the distributing trust, the unused credit will be allocated pro rata among such trusts on the basis of the fair market value of such trusts at that time.

Explanation:

Every Grantor will have a Generation-Skipping Tax Credit to allocate between Outright Skips and all Non-Owned Trusts he creates. At 1987 rate and exemption levels, the Generation-Skipping Tax Credit amount is \$417,000. The effect of the Generation-Skipping Tax Credit is to permit an individual to make \$834,000 of untaxed generation-skipping transfers.

a. Allocation of Credit While Grantor is Alive.

While the Grantor is alive, the credit will be allocated on a mandatory basis to cumulative transfers from Non-Owned Trusts to which the Grantor has transferred property and Outright Skips attributable to the Grantor. The mandatory use of the credit is the same as current law with respect to the use of the unified credit. The Grantor will keep track of the amount of credit available. Prior to the due date of the trust transfer tax return, the trustee will request the Grantor to supply the amount of remaining credit. The trustee will send a copy of the trust transfer tax return to the Grantor. The Grantor will thereby learn of the amount of the credit used.

The same procedure will be used where multiple trusts are involved. In the year in which the tentative tax liability exceeds the remaining credit, the credit will be allocated pro rata with respect to the amount of Taxable Distributions and Outright Skips occurring in that year.

b. Allocation of Credit After the Death of the Grantor.

The Grantor will be entitled to allocate the unused credit at death by any instrument which has binding effect under local law. The amount of the unused credit at death is the difference between the total credit and the amount used on all returns reporting Taxable Distributions and Outright Skips that occurred before the date of the Grantor's death. In the absence of a specific allocation by the Grantor, the unused credit will be allocated first to

any Surtax liability attributable to Outright Skips occurring at the death of the Grantor and then in proportion to the net asset value, at the estate tax valuation date, of trusts to which the Grantor has transferred property. If the Grantor is one of multiple Grantors, only the net asset value of the portion of the trust attributable to the Grantor will be taken into account and the credit allocated to that trust may only be used to offset the tax liability with respect to Taxable Distributions attributable to that portion.

Notwithstanding the foregoing, at any time after the death of the Grantor, any Non-Owned Trust may reallocate all or any portion of its remaining credit to any other Non-Owned Trust created by the same Grantor. If some portion of the credit is reallocated to a Non-Owned Trust created by multiple Grantors, the credit will only be available to offset the tax liability with respect to Taxable Distributions from the portion of the trust attributable to the Grantor.

If a Non-Owned Trust ceases to exist, and after its terminating distributions any unused credit remains, the trustee may reallocate that credit to any other Non-Owned Trusts created in whole or part by the same Grantor that remain in existence. In the absence of a specific allocation, the remaining unused credit will be allocated pro rata among the Non-Owned Trusts created by the Grantor on the basis of fair market value at the date the trust ceased to

exist.

The need for a reallocation mechanism and its operation may be illustrated by the following example. Assume a widowed Grantor, G, created two testamentary trusts. Trust A, funded with \$1,000,000, is a discretionary trust for the benefit of the Grantor's issue. Trust B, funded with \$500,000, is a discretionary trust for the benefit of the Grantor's grandchildren. By will the Grantor allocated \$300,000 of credit to Trust A, the balance to Trust B. One of G's children and three of G's grandchildren are involved in an accident and their aggregate medical expenses over time are paid by Trust A until it is exhausted. No portion of the credit allocated to Trust A was ever utilized. In order to prevent the wastage of this amount of the credit (which the Grantor could originally have allocated to Trust B), the credit will be reallocated to Trust B.

5. When A Taxable Termination Occurs.

A Non-Owned Trust will be deemed to terminate periodically (a "Taxable Termination") if the trust has beneficiaries assigned to generations below that of the Grantor and those beneficiaries are not members of the Excepted Class, or beneficiaries who are not assigned to generations.

- a. If any trust has beneficiaries assigned to generations below the Grantor and those beneficiaries are not members of the Excepted Class, a Taxable Termination will occur at such time, after the later of the death of the Grantor or the termina-

tion of the last interest of the last beneficiary who is a member of the Excepted Class, as the last Interest of the last beneficiary in the highest generation of beneficiaries not included in the trust's Excepted Class terminates.

- b. If a trust has no beneficiary assigned to a generation, a Taxable Termination will occur 35 years from the later of the death of the Grantor or, if the trust at any time had beneficiaries who were assigned to generations, 35 years from the later of the death of the Grantor, the termination of the last interest of the last beneficiary who was a member of the Excepted Class, or the last prior Taxable Termination, and at 35 year intervals thereafter.

Explanation:

a. When A Taxable Termination Occurs.

A trust that at no time has beneficiaries other than members of the Excepted Class will never have a taxable termination. If a trust has beneficiaries who are not members of the Excepted Class assigned to the generation below that of the Grantor, and the trust continues after the termination of the last Interest of the last beneficiary assigned to the highest generation of beneficiaries not included in the trust's Excepted Class, a taxable termination will occur. For example, assume G creates a testamentary discretionary trust for the benefit of his children and

grandchildren and great-grandchildren, remainder to great-grandchildren at the death of the last surviving great-grandchild. A taxable termination will occur at the death of the last grandchild of G.

If from the outset a trust has no beneficiaries who are assigned to generations a taxable termination will occur at 35 year intervals commencing 35 years from the death of the Grantor. If, prior to the time the trust has no beneficiaries assigned to a generation, it had beneficiaries who were assigned to generations, the 35 year period begins to run at the later of the death of the Grantor, the termination of the last Interest of the last beneficiary who was a member of the Excepted Class, or the last prior Taxable Termination.

b. Definition of Interest.

An Interest in a trust exists if a person has a right to receive distributions from the trust or is a permissible recipient of such distributions. However, individuals with nominal interests in a trust will be disregarded.

c. Nominal Beneficiaries Disregarded.

An Interest is a nominal interest and disregarded if, under all the facts and circumstances, the holder of the Interest was never intended to benefit from the interest.

d. Termination of Interest.

The interests of a generation will be deemed terminated, if, immediately after the termination of the Interest of a beneficiary there exists no other beneficiary assigned to the same generation with an Interest in the

trust.

6. Consequences of Taxable Termination.

When a Taxable Termination occurs, an estate tax at the maximum marginal transfer tax rate then in effect will be imposed upon the entire undistributed trust corpus.

- a. The unused portion of the Generation-Skipping Tax Credit allocated to the trust will be available to offset this tax liability.
- b. Any distribution occurring within nine months after a Taxable Termination will be treated as a Taxable Distribution. The value of the property distributed plus the tax attributable to the distribution will be eliminated from the base used for the computation of the tax on the Taxable Termination.
- c. After a Taxable Termination the amount of the trust's Generation-Skipping Tax Credit will be renewed. The amount of the post-Taxable Termination credit will initially be equal to the amount of the Generation-Skipping Tax Credit originally allocated to the trust increased by the amount of any Generation-Skipping Tax Credit originally allocated to any other Non-Owned Trust created by the same Grantor and transferred to the trust prior to the Taxable Termination, and decreased by the amount of such credit transferred by such trust to any other trust prior to the Taxable

Termination.

- d. After a Taxable Termination, the Excepted Class will include all beneficiaries assigned to the generation that is two generations below that of the youngest generation of beneficiaries included in the Excepted Class prior to the Taxable Termination.

Explanation:a. Consequences of a Taxable Termination.

Upon a Taxable Termination a tax, which is the equivalent of an estate tax, will be imposed on the amount of corpus that remains in the trust and is not distributed at or within nine months after the Taxable Termination. Any remaining Generation-Skipping Tax Credit allocated to the trust will offset this tax liability.

For example, assume a Taxable Termination occurs at a time when the trust assets are \$1,000,000 and the unused Generation-Skipping Tax Credit allocated to the trust is \$300,000. Assume also that at the time the Taxable Termination occurs, the trust is required to make a distribution of \$700,000 to A, who is not a member of the Excepted Class. The \$700,000 distribution to A is a Taxable Distribution. The tentative tax on that distribution is \$350,000. However, \$300,000 is offset by the trust's Generation-Skipping Tax Credit. The undistributed corpus subject to tax under the Taxable Termination rules is \$250,000 [\$1,000,000 minus the sum of the Taxable Distribution (\$700,000) and the tax on the Taxable Distribution

(\$50,000)]. The tax payable on account of the Taxable Termination is \$125,000 (50 percent of \$250,000).

b. Transfers Occurring After a Taxable Termination.

After a Taxable Termination, the trust will have a renewed Generation-Skipping Tax Credit initially equal to the amount of the credit originally allocated to the trust increased by the amount of the credit transferred to the trust prior to the Taxable Termination by the trustees of the Non-Owned Trusts created by the same Grantor and decreased by the amount of credit transferred by the trustee of the trust to other trusts created by the same Grantor. This renewed credit will be available to offset the tentative tax liability with respect to subsequent Taxable Distributions and the next Taxable Termination. The renewed credit may be reallocated to other Non-Owned Trusts created by the same Grantor but may not be utilized by any such trust until a Taxable Termination has occurred with respect to the transferee trust.

After a Taxable Termination, the Excepted Class will include all beneficiaries assigned to the generation that is two generations below that of the youngest generation of beneficiaries included in the Excepted Class prior to the Taxable Termination.

7. Deduction For Income Tax of Beneficiary.

The trust will be allowed a transfer tax deduction of [x] percent of the portion of any Taxable Distribution that constitutes taxable income to the recipient.

Explanation:

This provision adjusts the total tax liability of the trust to account for the fact that Taxable Distributions are subject to transfer taxation on the gross amount of the transfer even though those distributions constitute taxable income to the beneficiary to the extent they carry out trust distributable net income. In order for this adjustment to work properly, the trust will have the same accounting period for transfer and income tax purposes.

8. Repeal of Sections 2514 and 2041. Sections 2514 and 2041, relating to the transfer tax consequences of the possession of powers of appointment, will be repealed.

9. Examples.

The operation of the rules relating to Non-Owned Trusts are illustrated by the following examples.

Example 1: G transfers \$100,000 intervivos to an irrevocable trust pursuant to which the trustee has the discretion to pay income or principal to G's children, A, B and C. The trust is to terminate at the death of the last child of G and the corpus is to be distributed to G's grandchildren per capita. The trustee makes a transfer of \$20,000 to A.

Result: The distribution of \$20,000 is not a Taxable Distribution as A is a member of the Excepted Class.

Example 2: G, a widower, dies after having funded the intervivos trust in Example 1. Pursuant to G's will, his net estate after specific bequests and taxes is left in trust for the benefit of G's issue. The testamentary trust will terminate at the death of the last child of G and the corpus is to be distributed to G's grandchildren per stirpes. At G's death the value of the intervivos trust is \$200,000. G's net estate is \$1,000,000. At the death of G's last surviving child, the value of the intervivos trust is \$300,000 and the value of the testamentary trust is \$1,500,000.

Result: No transfers from the testamentary trust and the intervivos trusts to the children of G will be Taxable Distributions. The children of G are members of the Excepted Class. Any transfer from the testamentary trust to

a grandchild or great-grandchild of G will be a Taxable Distribution. In the absence of a specific direction by G, the generation-skipping tax credit remaining at G's death will be allocated 1/6 to the intervivos trust and 5/6 to the testamentary trust. At the death of the last child of G, both trusts terminate. The termination of each trust is a Taxable Distribution of \$200,000 and \$1,000,000 respectively because the tax is computed on a net gift basis. Any unused credit will offset the repetitive tentative tax liabilities of \$100,000 and \$500,000.

Example 3: G transfers property at death to a trust pursuant to which the trustee has the discretion to pay or accumulate income and principal to and among G's issue. The trust is to terminate at the date of the last to die of G's issue living at G's death. At G's death, G has three children (A, B and C) and two grandchildren (D and E) alive. T has created no other trusts. At the death of the survivor of D and E the trust has a value of \$1,500,000.

Result: Distributions from the trust to A, B and C are not Taxable Distributions. A, B and C are members of the Excepted Class. Distributions from the trust to all other beneficiaries will be Taxable Distributions. No Taxable Termination occurs at the death of the last survivor of A, B and C. The termination of the trust at the death of the survivor of D and E is a Taxable Distribution of \$1,000,000.

Example 4: G creates two testamentary trusts. Trust A is a discretionary trust in the amount of the

exemption equivalent for the benefit of G's spouse W and G's issue during the life of W, with corpus distributable to the children of G and W per capita at the death of W. Trust B is a marital deduction trust. G has created no other trusts.

Result: Trust B is an Owned Trust, Trust A is a Non-Owned Trust. Distributions to W and the children of G and W are not Taxable Distributions as they are members of the Excepted Class. Distributions to any other beneficiaries will be Taxable Distributions. Terminating distributions to the children of G and W will not be Taxable Distributions because the children are members of the Excepted Class.

Example 5: G creates a discretionary trust for the benefit of his wife W, his cousin C and his children D and E, remainder to grandchildren per capita at the death of the survivor of W, C, D and E.

Result: Distributions to W, C, D and E are not Taxable Distributions because they are made to members of the Excepted Class. At the death of the survivor of W, C, D and E, the trust terminates and a Taxable Distribution occurs.

Example 6: G creates two testamentary trusts. Trust A is a discretionary spray trust for the benefit of child X and child X's issue living from time to time. Trust A is to terminate at the death of the last child of X living at the death of G. Trust B is identical except that it is for the benefit of child Y and Y's issue. X predeceases Y. G has created no

other trusts and allocates his \$417,000 skipping tax credit \$300,000 to Trust A, \$117,000 to Trust B.

Result: Distributions from Trust A and Trust B during the term of each trust to any beneficiary other than X or Y are Taxable Distributions. Trust A has a \$300,000 credit; Trust B a \$117,000 credit. A Taxable Distribution occurs at the death of the last child of X living at the date of the creation of Trust A. The results are identical for Trust B.

Example 7: The facts are the same as Example 6, except that Trust A is to pour over into Trust B if X dies without issue. X predeceases Y without issue.

Result: The death of X terminates Trust A but no Taxable Distribution occurs. When the corpus of Trust A is added to Trust B, Trust B's credit is increased by the amount, if any, of Trust A's unused credit.

Example 8: G leaves his entire estate to a discretionary testamentary trust for the benefit of his issue, the trust to terminate upon the death of the last survivor of G's grandchildren living at G's death. G has created no other trusts. Subsequently S dies and leaves her entire estate to the G testamentary trust. S has created no other trusts. Prior to the addition of S' \$1,000,000 net estate to the G trust, the trust had a value of \$1,500,000. The trust had made prior Taxable Distributions of \$200,000 thereby using \$100,000 of its credit.

Result: The issue raised by this example is how to aggregate the credits of two Grantors of property to a Non-

Owned Trust. Unless the trustee of the trust has elected to administer the trust in solido, the single trust is treated as two separate trusts and the credit of each Grantor is applied to offset the tentative tax liability attributable to Taxable Distributions from each "separate trust."

If the trustee has elected to administer the trust in solido, Taxable Distributions will be allocated to each Grantor in proportion to the fair market value of the contributions of each Grantor measured at the time the last contribution was made to the trust. The credit of each Grantor will be available to offset the tentative tax liability resulting from the Taxable Distribution allocated to the share of each Grantor. Thus, in this example, Taxable Distributions from the trust after the time of S' contribution would be treated as allocated 3/5 to G's share and 2/5 to S's share. The credits of G (\$317,000) and S (\$417,000) would be applied against the separate tax liability thus computed.

Example 9: G, who is unmarried, creates a testamentary discretionary trust for the benefit of his butler B, his cook C, his gardener D and their children for 40 years, remainder to the children of B, C and D per capita.

Result: Since B, C, D and their children are not descendants of the grandparents of G, they are not assigned to generations. Distributions to them are Taxable Distributions. A Taxable Termination occurs 35 years after the creation of the trust. Thereafter the trust is treated as a new taxpayer. The distribution of the trust assets after 40 years is a Taxable Distribution.

Owned Trusts

1. When A Trust Is An Owned Trust. From and after the earliest time a transfer is complete for gift or estate tax purposes, a beneficiary will be treated as the Owner of the trust to the extent that

- a. a gift or estate tax marital deduction was allowed for the transfer to the trust, or
- b. if the beneficiary is not the spouse of the Grantor, the beneficiary has an absolute non-lapsing right to withdraw principal, or
- c. if the beneficiary is not the spouse of the Grantor,
 - (1) the trustee has the power to pay or apply income to or for the benefit of the beneficiary at any time during the lifetime of the beneficiary, and
 - (2) no distribution may be made to anyone other than the beneficiary during the lifetime of the beneficiary except with the consent of the beneficiary.

Explanation:

a. Marital Deduction Transfers.

A transfer of property to a trust as to which a marital deduction was allowed causes the trust to be treated as an Owned Trust because, under existing law, the trust property is included in the transfer tax base of the transferee spouse.

b. Absolute Non-Lapsing Right to Withdraw.

An absolute non-lapsing right to withdraw is an unrestricted right to withdraw for the life of the beneficiary or until the trust is terminated by its terms. From and after the time a beneficiary possesses such a right, the beneficiary is treated as the Owner of the property subject to the right. The beneficiary of a trust qualifying for the present interest exclusion under §2503(c) is treated as possessing an absolute non-lapsing right to withdraw the portion of the trust to which §2503(c) applies. An absolute non-lapsing right to withdraw, whether or not exercised, takes priority over any other interest the beneficiary may possess.

c. Other Interests.

A beneficiary is treated as the Owner to the extent that, and for so long as, the trustee has the power to pay or apply income to or for the benefit of the beneficiary, and no person other than that beneficiary may receive income or corpus from the trust during the beneficiary's lifetime without the consent or direction of the beneficiary.

2. Extent to Which Beneficiary Is Treated As Owner. A beneficiary will be treated as the Owner of a trust only to the extent the interest, if in less than the entire corpus, is described in terms of a fractional share of the trust.

Explanation:

A trust in which a beneficiary possesses an annuity interest is not an Owned Trust. Where multiple beneficiaries are involved, the effect is to limit Owned Trusts

to trusts as to which the separate share rules of Reg. §1.663(c)-1 would apply.

3. Transfer From Trust During the Life of the Owner.
Any transfer during the lifetime of the Owner to a third party from that portion of the trust the Owner is treated as owning will be treated as a transfer by the Owner for all purposes of the transfer tax.

- a. The transfer of any part of the income interest owned by the Owner is a transfer of the value of such part. The transfer does not cause the Owner to cease being treated as the Owner of the corpus to which the income interest related. The same rule will apply if the Owner transfers the entire income interest. If, after such a transfer, the Owner possesses no right to receive, or to direct the distribution of, corpus, the Owner may elect, on a timely filed gift tax return, to transfer the remainder interest in the corpus to which the income interest related.
- b. The termination of a portion of an Owner's interest in the trust is treated as a transfer by the Owner of that portion.
- c. The Owner will be entitled to reimbursement from the trustee for the amount of the gift tax payable with respect to such a transfer.

Explanation:a. Transfer of Corpus.

When a trustee conveys trust property with the consent of or at the direction of the Owner, the Owner will be treated as making a gift equal to the value of the property transferred. The Owner will be treated as the transferor of the property for all purposes of the transfer tax. Therefore, the §2503(b) present interest exclusion, the §2503(e) exclusion, gift splitting and the gift tax marital and charitable deductions will be allowable to the extent they would be allowable if the identical transfer were made from property owned outright by the Owner.

b. Transfer of Income Interest By Beneficiary.

The value of any transferred income interest will be treated as a gift of the value of the income interest by the Owner, subject to normal gift tax rules. Where the value of the transferred interest cannot be determined using generally accepted valuation methods, the gift will not be complete until income distributions are actually made to transferees.

If the Owner transfers the entire income interest and retains no right to receive or direct the distribution of corpus, the Owner may elect to transfer the remainder interest in the corpus to which the transferred income interest related. Thus, for example, if G creates a trust to pay income to A for life, remainder to B and A transfers the income interest to C, the value of the transferred income interest is a gift by A. If A does nothing more, the

value of the corpus of the trust will be included in A's estate at A's death. However, A may elect, on a timely filed gift tax return reporting the transfer of the entire income interest, to transfer the remainder interest in the corpus to which the income interest related.

c. Reimbursement Right for Gift Tax Liability.

It is contemplated that within a reasonable period after the end of the calendar year but prior to April 15, the trustee of an Owned Trust will file an information return with both the Owner and the Internal Revenue Service setting forth the gross value of the transfers attributed to the Owner during the relevant accounting period. The Owner will then be entitled to reimbursement from the trustee for the gift tax attributable to the transfer.

In the case of multiple transfers by the Owner, e.g., transfers by the Owner outright as well as transfers from trusts the Owner is treated as owning, the Owner will be entitled to reimbursement of the Owned Trust tax liability on a marginal rate basis. Where multiple trusts are involved, the reimbursement right will be allocated in proportion to the transfers from each trust. Trustees will be entitled to verify the amounts claimed by requesting a copy of the transfer tax return of the Owner.

4. Termination of the Interest of the Owner at Death.

Where the interest terminates at death, the portion of the trust corpus deemed owned is included in the Owner's gross estate. The Owner's estate will be entitled to reimburse-

ment for the transfer tax attributable to the inclusion of the trust corpus determined on an incremental basis.

5. Nominal Owners. Nominal Owners will be disregarded.

Explanation:

A beneficiary will be a nominal owner if under all the facts and circumstances the beneficiary was never intended to benefit from the trust.

6. Relief Provision for Too Frequent Imposition of Tax. Where the Grantor is in the same generation as or a younger generation than the Owner, a §2013 type credit would be available upon the termination of the interest of the Owner without a phase out. Where the Grantor is in a higher generation than the Owner or the Owner is not assigned to a generation, the §2013 type credit would be available, but would phase out. For purposes of determining the availability of the credit, the Grantor is the last prior person treated as the Owner of the trust.

Explanation:

a. Availability of Credit.

The allowance of a §2013 type credit without a phase out is intended to assure that in the case of sequential terminations of Owned Trusts owned by individuals in the same or higher generations than the Grantor no more than one transfer tax, determined by reference to the largest transfer tax base of any Owner, is imposed. The §2013 credit will be available at the death of an Owner.

b. Definition of Grantor.

For purposes of determining whether the credit is available on a non phased out basis, the Grantor is the original Grantor and then any other individual who is an Owner of an Owned Trust.

7. Election to Be Treated As A Non-Owned Trust.

Except for trusts which qualified for the marital deduction, a Grantor may elect to have an Owned Trust treated as a Non-Owned Trust. The trustee of an Owned Trust created at the death of the Grantor, or created by reason of a distribution from a Non-Owned Trust, may also elect to have the Trust treated as a Non-Owned Trust. Any such election must be made with respect to the entire trust corpus on a transfer tax return timely filed by reference to the date of the first transfer of property to the trust. The election will be irrevocable.

Explanation:

An election to treat an Owned Trust as a Non-Owned Trust may be evidenced in the trust instrument. To be effective, however, it must be made on a gift tax return timely filed by reference to the date of the first transfer of property to the trust. An election will be irrevocable and will apply to the entire trust corpus. All subsequent transfers to the trust will be governed by the election no matter who is the transferor.

8. Examples

The application of the foregoing rules is illustrated by the following examples.

Example 1: G transfers property in trust to pay the income no less often than quarterly to his brother A for life, remainder to A's son B.

Result: A is the Owner of the trust. This determination will have no transfer tax consequences during the life of A because distributions to A are not subject to tax. At A's death, the trust corpus will be added to A's transfer tax base and will be subject to tax.

Example 2: G transfers property in trust to pay or accumulate income to or for the benefit of his nephew B during B's life. At B's death any accumulated but unpaid income is to be distributed as B may direct by will to any person other than to or for the benefit of B's estate, with remainder to B's son C in default of exercise of B's power of appointment.

Result: Income may be paid to B, no part of the income of this trust may be paid to any person other than B during B's life and no person may divert corpus during B's life. Therefore B is the Owner of the trust. Distributions to B are not subject to tax. At B's death, the trust corpus will be added to B's transfer tax base.

Example 3: G transfers property in trust granting the trustee discretion to pay or accumulate income to A during A's life. At A's death, the trust corpus is to be distributed to B.

Result: The income of the trust may be paid to A and may not be paid to anyone other than A during A's life. No person can divert corpus during A's life. Therefore, A is the Owner of the trust.

Example 4: G transfers property in trust directing the trustee to pay income or principal to A during A's life for A's health, maintenance or support. At A's death, the remaining trust corpus is to be distributed to B.

Result: While A is entitled to distributions from this trust only if necessary for A's health, maintenance or support, no other person may receive distributions of income or corpus during A's life. Therefore A is the Owner of the trust. If, at the time of the transfer to the trust, it appeared, based on the assets owned by A, that A would never receive a distribution from the trust, A would be a nominal owner and the trust would be a Non-Owned Trust.

Example 5: G creates a trust granting the trustee discretion to pay or accumulate income or principal for the benefit of A for life. A is granted a power to appoint the trust corpus or income to any person other than A during A's life. At A's death the trust corpus is to be distributed to B.

Result: While A is not assured of the receipt of any income from the trust, A is the only potential income beneficiary during A's life. No person other than A possesses the power to direct the income or corpus to

another during A's life. Accordingly, A is the Owner of the trust. No distribution to A will be taxable. Any distribution to a third party pursuant to A's direction will be treated as a transfer by A. At A's death the trust corpus will be added to A's transfer tax base.

Example 6: G transfers property to X as trustee, income to A for life, remainder to B. X has the discretion to distribute corpus to C for C's comfortable maintenance and support.

Result: A is entitled to all the income from this trust. However, X has the power to distribute corpus to C without the consent of A. The trust is a Non-Owned Trust.

Example 7: G transfers property in trust to pay the income to his son A for life, reversion to G, or if G dies before the termination of the trust, remainder to B. A dies after 5 years. The value of G's reversion has at all times exceeded 5% of the trust corpus.

Result: A is entitled to all the income from this trust for life and there is no power in any person to divert income or corpus from A. G has at all times retained a reversionary interest in the trust sufficient to cause inclusion in G's gross estate if G were to predecease A. Nevertheless, A is the Owner of the trust because the transfer was complete for gift tax purposes. Since A is the Owner, distributions to A are not taxable. At A's death the property is included in A's transfer tax base. At G's death a \$2013 credit without phase out may be available.

Example 8: Same as Example 7 except that G dies after 5 years survived by A.

Result: At G's death, the original transfer becomes complete for estate tax purposes and the corpus of the trust is included in G's estate. However, A has been treated as the Owner of the trust from its inception. Therefore G's death has no additional tax consequences to the trust (although G's estate may have an estate tax liability).

Example 9: G transfers property in trust to pay the income to G for life, then to A for life, remainder to B. G predeceases A and B.

Result: G is the Owner of this trust. Transfers to G are not subject to tax. The corpus of the trust is included in G's estate under §2036. After G's death, A is the Owner of the trust.

Example 10: G transfers property in trust with income to be paid to or accumulated for the benefit of A or B until the death of the survivor. A is given a lapsing "Crummey power" over annual transfers by G but not in excess of the greater of \$5000 or 5% of the trust corpus. A dies without ever having exercised the "Crummey power."

Result: Because the power of withdrawal is a lapsing power, it does not cause A to be treated as the Owner of any portion of the trust. Accordingly the trust is a Non-Owned Trust.)

Example 11: G transfers property in trust with one-half of the income payable annually to A, the

balance of the income to be paid to or accumulated for the benefit of A, B and C in the discretion of the trustee. The trust is to terminate at the death of A with remainder payable to the issue of A and B and C per stirpes. A predeceases B and C.

Result: Under the separate share rule, this trust would be treated as two separate trusts each containing one-half of the total corpus. One share pays the income currently to A, with remainders over. The other is discretionary with respect to income, with remainders over. A is the Owner of the first share. Thus at A's death one-half of the trust corpus will be included in A's transfer tax base. The second share is not owned by any individual and is, therefore, a Non-Owned Trust.

Example 12: G transfers property in trust to pay an annuity of \$5000 per year to A for life, remainder to B.

Result: Although A is entitled to payments from this trust for life, the right is not defined in terms of an interest in income from a fractional or percentile share of trust corpus. Therefore A is not treated as the Owner of any portion of the trust and the trust is a Non-Owned Trust.

Example 13: G transfers property in trust granting the trustee discretion to pay or accumulate income and corpus among his children A and B for their comfortable support during their joint lives, then to pay to or accumulate income and corpus to the survivor for life, remainder to

those other than the survivor's estate as the survivor may appoint by will, but in default per stirpes to the issue of A and B.

Result: While A and B are both alive, no individual is treated as the owner of the trust and the trust is an Non-Owned Trust. Upon the death of either A or B, there will be a transfer of the remaining corpus to a new trust of which the survivor will be treated as Owner. The distribution is not a Taxable Distribution because it is made to an Owned Trust owned by a beneficiary who is a member of the Excepted Class. Distributions thereafter to the survivor will not be subject to tax. At the death of the survivor the entire trust corpus will be included in the transfer tax base of the survivor.

Example 14. G transfers property in trust to pay one-half the income currently to each of A and B for their joint lives, then all the income to the survivor for life, remainder to the issue of A and B per stirpes.

Result: During the joint lives of A and B the separate share rule will apply. A and B are each entitled to current income of one-half the trust. A and B therefore will each be the Owner of one-half of the trust corpus. One-half of the trust corpus will be included in the transfer tax base of the first to die. Thereafter, the survivor will be treated as the Owner of the entire trust because all the income is payable currently to the survivor. The entire trust corpus will be included in the survivor's transfer tax

base at the death of the survivor. A §2013 credit without a phase out may be available.

Example 15: G transfers property at death to two trusts. Trust A is to pay income or principal to child X for life; thereafter income or principal is distributable in the discretion of the trustee to and among the issue of X. The trust terminates at the death of the last child of X living at the date the trust was created. Trust B is identical except that it is for the benefit of G's child, Y. Neither X nor Y create any intervivos or testamentary trusts.

Result: While X and Y are alive, Trusts A and B are Owned Trusts. X is the Owner of trust A. No trust distributions to X will be taxable. At X's death, the trust corpus will be added to X's taxable transfers and included in X's transfer tax base. Y is the Owner of trust B. No trust distributions to Y will be taxable. At Y's death, the trust corpus will be added to Y's taxable transfers and included in Y's transfer tax base.

At the death of X, Trust A becomes a separate taxpayer and X, not G, is considered the Grantor. Distributions to X's children are not Taxable Distributions as X's children are in the Excepted Class. Distributions to any other beneficiaries are Taxable Distributions. If X has not created any other trusts, X's full Generation-Skipping Tax Credit is available to the trust. The terminating distributions occurring at the death of the last of X's children

living at the date of the creation of the trust are not Taxable Distributions. The results are identical for Trust B.

Example 16: The facts are the same as Example 15 except that Trust A provides that upon the failure of X's issue, Trust A pours over into Trust B. X dies without issue while Y is alive.

Result: The termination of Trust A due to X's death causes the corpus of Trust A to be included in X's transfer tax base. The corpus of trust A is added to that of Trust B which is an Owned Trust. At the death of Y, the corpus of Trust B is included in Y's transfer tax base and the portion attributable to Trust A is eligible for the relief from multiple imposition of tax in a single generation. After the death of Y, Trust B is a Non-Owned Trust. Trust B will have a single Generation-Skipping Tax Credit (it does not receive any credit from X) as Y did not, on the assumed facts, create any other trusts.

Surtax on Outright Skips1. Imposition of Surtax.

A Surtax will be imposed on Outright Skips.

Explanation

A Surtax will be imposed on the Grantor or Owner of an Owned Trust with respect to transfers of property that are defined as Outright Skips. The Surtax is designed to duplicate the tax result that would have occurred had the property been transferred by a Non-Owned Trust to the recipient of the property.

2. Outright Skip Defined.

An Outright Skip is a taxable gift or transfer at death by an individual or an Owned Trust to:

- a. an individual assigned to a generation more than one below that of the Grantor or who is not assigned to a generation and is more than 35 years younger than the Grantor.
- b. an Owned Trust owned by such an individual, or
- c. any entity other than a Non-Owned Trust.

Explanation:

Outright Skips include any transfer by an individual or an Owned Trust to any individual assigned to a generation more than one below that of the grantor or to an individual not assigned to a generation who is more than 35 years younger than the Grantor, to an owned trust owned by any such individual, or to any entity other than a Non-Owned Trust. For example, a transfer by G to his grandson or an Owned Trust owned by his grandson is an Outright Skip.

Similarly, a transfer by G to his butler who is 38 years younger than G is an Outright Skip. Any transfer by G to any partnership or corporation is also an Outright Skip.

3. Amount of Surtax.

The amount of the Surtax will be equal to the sum of

- a. the tax that would have been payable by a Non-Owned Trust created by the Grantor (after reduction for the remaining portion, if any, of the Grantor's Generation-Skipping Tax Credit) had the property been transferred by the Grantor to such trust and immediately distributed to the transferee, and
- b. in the case of an Outright Skip that is
 - (1) a gift, the amount of the gift tax that would have been payable by the Grantor had the amount of the gift been increased by the amount of tax determined in a., or
 - (2) a transfer at death, the amount of estate tax that would have been attributable to the amount determined in a. had the estate of the Grantor made a net distribution of such amount.

3. Explanation:

The amount of the Surtax will vary depending upon whether the Outright Skip was an inter vivos or deathtime transfer. In both cases the objective is to duplicate the tax result that would have occurred had the property been

transferred to a Non-Owned Trust and immediately thereafter transferred by the Non-Owned Trust in a Taxable Distribution to the ultimate transferee.

The first component of the Surtax is the amount of tax that would have been paid by a Non-Owned Trust (taking into account the Generation-Skipping Tax Credit available to the Trust) had the Non-Owned Trust made a Taxable Distribution of the value of the property that was the subject of the Outright Skip. For example, assume G transfers \$1,000,000 outright to his grandson and G has fully utilized his Generation-Skipping Tax Credit. The first component of the Surtax, whether G's transfer occurs during G's life or at death, is \$500,000 (the amount of tax payable on account of a \$1,000,000 Taxable Distribution from a Non-Owned Trust). If G had previously used none of his Generation-Skipping Tax Credit, the first component of the Surtax would be \$83,000 (\$500,000 tentative tax liability - \$417,000 credit).⁶

The second component of the Surtax depends upon whether the Outright Skip was a gift or a deathtime transfer. In the case of an Outright Skip that was a gift, the first component is increased by the additional gift tax that would have been payable by the Grantor had the amount of the first component been an additional gift by the Grantor. Thus, in the foregoing example, if G is in a 50 percent gift tax

⁶G would have no remaining Generation-Skipping Tax Credit.

bracket, the second component is \$250,000 if G has previously used his entire credit and \$41,500 if G had previously used none. The total surtax is \$750,000 and \$124,500 respectively.⁷

In the case of an Outright Skip that was a transfer at death, the second component is the amount of estate tax that would have been required to enable the estate to make an additional transfer to the trust of an amount equal to the first component. The determination of the amount of estate tax required to make such a distribution shall take into account the effect of the marital and charitable deductions and available credits in a manner to be prescribed in Regulations. Thus, in the preceding example, if the \$1,000,000 transfer by G had occurred at death and G's estate was taxable at a 50 percent rate, the Surtax would be \$1,000,000 (\$500,000 + \$500,000) if G had previously utilized his entire skipping tax credit and \$166,000 (\$83,000 + \$83,000) if he had used none.⁸

⁷The proof is set forth at page 103.

⁸The proof is set forth at page 104.

Part III

Commentary on Reporters' Recommendations

In this part the Reporters describe the considerations that led to their Recommendations. The material is organized in the order their Recommendations were presented in the preceding part.

Non-Owned Trusts

1. Taxation of Distributions From a Non-Owned Trust.
- a. Requirement That an Inter Vivos Transfer Be Complete for Gift Tax Purposes.

The Reporters considered, and rejected, two alternatives as to when a trust would become a Non-Owned Trust. The first was that a trust would become a Non-Owned Trust only after a transfer became wholly complete for gift and estate tax purposes. This alternative was rejected principally because of the difficulty a trustee would have, particularly in cases involving §2037, determining the time a transfer was no longer includible in the Grantor's estate. The second alternative was that a trust would become a Non-Owned Trust after a transfer was no longer revocable, in a property law sense, by the Grantor. This alternative was rejected on the grounds that it would introduce a new concept into transfer taxation and that, in any event, it would be uncertain in application because the scope of the term "revocable" may differ from jurisdiction to jurisdiction.

The Reporters do recommend a change to the Regulations test as to when a transfer is complete for gift tax purposes. Under current law, a transfer is complete if certain retained powers may be exercised only with the consent of an adverse party. There is no clear definition of the term "adverse party." Moreover, §§2036 and 2038 do not contain a similar limitation on the taxability of retained powers. Elimination of the concept in the gift tax would remove a troublesome definitional question and conform the gift tax consequences of a retained power to those of the estate tax.

2. Taxable Distributions

a. Exclusion For Transfers to Members of an Excepted Class.

The Reporters sought originally to treat virtually all transfers from trusts as Taxable Distributions.⁹ Accordingly, they had recommended that all distributions (other than those to charity or in payment of the medical and tuition expenses of a beneficiary) be treated as Taxable Distributions unless the distribution was made to a narrow class of individuals closely related to the Grantor. The decision to exclude transfers to a limited class of beneficiaries was made because the Reporters recognized that it would be unacceptable to treat all transfers from trusts as subject to transfer tax regardless of generation assignment and the relationship of a beneficiary to the Grantor.

⁹The concept is not novel. It is similar to the United Kingdom Capital Transfer Tax.

If no exceptions were made, a transfer to a discretionary trust in which, for example, the spouse of the Grantor was a beneficiary would be taxable and subsequent distributions to the spouse would also be taxable. Thus a transfer to a spouse of the Grantor could be subject to two taxes as compared to current law, under which a similar disposition would be taxable only once—at the time of the transfer to the trust. The Reporters concluded that the former result was unacceptable.

Similar consequences would occur with respect to transfers to and then from discretionary trusts created for members of Grantor's family. Double tax consequences could be avoided by creating an Owned Trust for the benefit of each family member.

Unless some accommodation were made, Grantors who desired to avoid double tax would have to give up the flexibility of a discretionary trust. In particular, the utility of a discretionary credit shelter trust for family members would be impaired.

Because sound non-tax reasons exist for the creation of a discretionary trust for the benefit of family members, the Reporters sought to limit the potential double tax consequences of a Non-Owned Trust. Accordingly the Reporters recommended the creation of a class of distributees to whom tax free distributions may be made. By limiting the Excepted Class to close family members and spouses, the Reporters believed they achieved an adequate compromise

between the theoretical consequences of their concept that all trust distributions should be subject to transfer tax and the realities of sound, non-tax family financial planning.

The Reporters' original recommendations increased the tax burden on transfers made through a trust to non-Excepted Class beneficiaries in the same or a higher generation than the grantor. A number of the Consultants expressed concern over this result, and, after lengthy discussion, the Tax Advisory Group concluded that the Excepted Class should be expanded to include any person assigned to a generation higher than, the same as or one below that of the Grantor. This conclusion had its basis in the view of the Consultants and the Tax Advisory Group that the problem with current law is the failure to tax generation-skipping transfers and not, as the Reporters asserted, the failure tax all skipping transfers.

The current recommendations reflect the former position. As a result, the tax consequences of a transfer of property by a Grantor to a beneficiary assigned to a higher, the same, or generation immediately below that of the Grantor are the same whether the transfer is outright or to a Non-Owned Trust which then distributes the property. A Grantor will incur a single transfer tax upon a transfer of property outright to his son. He will also incur a single transfer tax if the property is transferred to a Non-Owned Trust and then distributed to the son. In the latter case, the transfer to the trust is taxable but the distribution to

the son is not.

A distribution to any other beneficiary is a Taxable Distribution. Thus, if a transfer is made to a grandchild of the Grantor, a second tax is collected (after the trust's Generation-Skipping Tax Credit is exhausted). In substance, the trust in such a case is the intermediate generation transferor one seeks if the transfer tax is to be imposed at least once a generation.

When this material was presented to the Council, it was suggested that the Excepted Class be expanded to include orphan grandchildren of the Grantor under the age of 25. It was further suggested that a dollar cap, similar to the current law grandchild exclusion, be placed on the amount that could be distributed to these new members of the Excepted Class. The Reporters have carefully considered this suggestion and have concluded that it is both complicated and unnecessary.

The suggestion would inject precisely the type of complexity the Reporters sought to avoid. The term "orphan" would have to be defined. Would that status have to exist at the time the trust was funded or at the time a distribution was made? Trustees of multiple trusts would have to coordinate monitoring any dollar cap that was imposed. Would that dollar cap be determined on a per donee basis or would it be an aggregate limitation on excluded transfers? The exclusion would create an incentive to make tax free distributions to orphan grandchildren immediately prior to

their twenty-fifth birthday solely for tax purposes and without regard to the non-tax wisdom of that action. Finally, as experience with the recently repealed orphan's deduction (§2057) demonstrates, draftsmen would be inclined to put appropriate language in instruments even if it is unlikely that the provisions would ever be necessary. This would undoubtedly increase the transaction costs associated with the recommendations.

In addition, all distributions for tuition and medical expenses of grandchildren are excluded from the scope of the tax. Furthermore, the generation-skipping tax credit will permit \$834,000 of additional transfers to be made before any distributions become taxable. Thus, the Reporters believe grandchildren, even if orphans, are adequately protected.

Under the Reporters' recommendations only individuals who are related to the Grantor or the Grantor's spouse are assigned to generations. This is a departure from the generation assignment rules of current Chapter 13. Under the suggested rule, a distribution to an individual who is not a family member will be a Taxable Distribution. The Reporters believe this is appropriate as any attempt to assign non-family members to generations necessarily results in arbitrary tax results. The Tax Advisory Group agreed, although not unanimously.

b. Medical and Tuition Expense Exclusion.

The Reporters have recommended the exclusion of trust distributions in payment of medical and tuition expenses of beneficiaries if such payments would have been excluded under §2503(e) when made by an individual.

The conceptual basis for the current §2503(e) gift tax exclusion is unclear. Some view it as an attempt to create a federal transfer tax support standard. Others view it as an attempt to define medical and tuition expense payments as consumption payments (and not a wealth transfer) by the donor. Under either rationale, it is arguable that the exclusion should not be available to trusts because trusts do not consume nor do they have support obligations.

A trust, however, is often used as a source of funds to pay precisely the same expenses which, if paid by the Grantor, would be excluded under §2503(e). The exclusion could, therefore, be made available to the extent the trust made payments the Grantor otherwise would have made. Limiting an exclusion in this way would require a subjective and administratively costly inquiry before the exclusion became allowable. Consequently, and principally because the Reporters believe that consistency with individual treatment is

appropriate here, the exclusion should be allowed.¹⁰

c. Distributions From One Non-Owned Trust to Another Non-Owned Trust.

This rule provides flexibility in the disposition of a Grantor's assets. There are sound non-tax reasons for the creation of separate trusts and there is no sound reason to impose tax consequences on a distribution that would not have been a taxable event if the Grantor had created a single trust rather than multiple trusts.

d. Distributions to Other Entities.

A distribution to any other entity is a Taxable Distribution. The Reporters considered, and rejected, a rule that would exclude distributions to entities to the extent owned by members of the Excepted Class. Apart from the case where an entity is owned exclusively by members of the Excepted Class the Reporters were unable to devise an acceptable method of determining the excluded amount. While the measurement problem does not arise with respect to distributions to entities owned exclusively by members of the Excepted Class, providing an exclusion for such distributions would require trustees to verify the ownership of the distributee. The Reporters believe that complicated and burdensome information exchange requirements would therefore be required and, on administrative grounds, have concluded that distributions to such entities should not be

¹⁰The Reporters also believe that the class of beneficiaries for whom excluded payments may be made should be restricted. However, that is principally a gift tax issue.

excluded.

e. Denial of A Present Interest Exclusion.

The Reporters do not recommend the allowance of a present interest exclusion for trust distributions.

The gift tax present interest exclusion was originally enacted for administrative reasons, to eliminate the need for transferors to account for gifts of small amounts or value. Since trustees have to account, as a non-tax matter, for all distributions, the justification for the exclusion is inapplicable to trusts. Moreover, if each trust created by a Grantor was entitled to exclude the first \$10,000 distributed annually to a beneficiary who was not a member of the Excepted Class, pressures to distribute would be created and the erosion of the tax base would be significant. If all trusts created by a Grantor were entitled to a single \$10,000 exclusion, an administratively burdensome procedure would be necessary to determine which distributions were excluded.

The Reporters recognize that draftsmen may be tempted to achieve the substantive equivalence of allowing the present interest exclusion by directing the distribution of up to \$10,000 annually to members of the Excepted Class in the hope that those transferees will subsequently transfer that amount to younger generation beneficiaries. However, they do not believe that possibility is sufficient to outweigh their conceptual and administrative objections to the allowance of the exclusion.

The Tax Advisory Group was polled on this question and agreed with the Reporters.

f. Denial of Gift Splitting.

The Reporters do not recommend gift-splitting between the trust and the spouse of the settlor.

Some might argue that gift-splitting is a logical corollary of permitting an exclusion for transfers to a spouse of the Grantor. The argument is that since the trustee might have distributed one-half of the total transfer to the ultimate donee and the other one-half tax free to the spouse of the Grantor who would then convey it to the ultimate donee, gift-splitting should be permitted to eliminate the need for the intermediate transfer.

Gift-splitting historically was an attempt to provide separate property state residents with an election to achieve the transfer tax result that occurred in a community property state where a transfer of community property was treated as made one-half by each spouse. After the enactment of an unlimited marital deduction in ERTA, gift-splitting could be viewed simply as a short cut to the transfer tax consequences that would have occurred had a transferor first transferred to his spouse one half of the property ultimately passing to the donee with the transferee spouse then transferring that property to the ultimate donee. The situation of a trustee and beneficiary-spouse of the Grantor is simply not the same as a husband and wife transferring property to a third party. In the

latter situation it may be appropriate to assume that gift-splitting is a convenient substitute for two transactions that would otherwise take place. Where a trustee initiates the transfer that presumption is more tenuous.

3. Taxable Distributions Treated As Gifts And Taxed At The Maximum Marginal Rate.

a. Treatment As Gifts.

The Reporters would prefer to have a uniform definition of the tax base, stated either as a tax inclusive (estate tax) base or as a tax exclusive (gift tax) base. However, since the tax base is different for the gift tax and the estate tax, the Reporters retain the distinction in their proposal. Thus, all Taxable Distributions are treated as gifts. The effect of treating Taxable Distributions as gifts is to reduce the tax rate, when measured on a tax inclusive basis, from 50 percent to 33 1/3 percent.

As in the present estate and gift tax structure, transfers treated as gifts incur a lower tax rate than transfers subject to estate tax. The Reporters have recommended that the tax base for Taxable Terminations be calculated by reference to a tax inclusive (estate tax) base. This difference in base raises the question how distributions which occur at the time of Taxable Termination should be treated. For the reasons discussed at pages 78 and 79, the Reporters recommend that such distributions should be treated as Taxable Distributions.

b. Taxable at Maximum Marginal Rates.

As explained immediately below, taxation of Taxable Distributions at the maximum marginal transfer tax rate is a product of the need to develop an administrable system of aggregating all trusts created by a single Grantor.

4. The Generation Skipping Tax Credit.

a. The Theory of the Generation-Skipping Tax Credit.

Every system proposed to deal with generation-skipping transfers has included some device to assure that taxation of such transfers begins at an appropriate level. Thus, current Chapter 13 contains an exclusion for the first \$250,000 of transfers to a grandchild of the Grantor and the Treasury proposal contains a \$1,000,000 exemption. The Generation-Skipping Tax Credit proposed by the Reporters serves the same function. At a credit level of \$417,000 the first \$834,000 of generation-skipping transfers will not be subject to tax.

The credit amount represents the total tax saving that results from the creation of one additional transfer tax taxpayer in the generation below the Grantor. When coupled with the taxation of all Taxable Distributions from Non-Owned Trusts created by a Grantor, it provides the simplest method the Reporters could devise to assure that transfers from all trusts created by a Grantor would be subject to tax on an aggregate basis.

The dollar amount of exempted transfers under the Reporters' recommendations is less than the \$1,000,000

proposed by the Treasury. However, an exclusion for medical and tuition payments is provided. The Treasury exemption applies to transfers made to generation skipping trusts. The effect of the exemption is to remove from the reach of the tax, subject only to the limitations imposed by the applicable rule against perpetuities, not only the \$1,000,000 exempt amount but also any appreciation that occurs after the exemption is claimed with respect to the transferred property. Thus, to achieve simplicity, the Treasury proposal abandons the notion of periodic imposition of tax with respect not only to the exempt amount but also its growth.

The Reporters do not believe this is sound policy. In contrast, they rely on a tax credit to limit the scope of the system. While this means that no trust has absolute assurance that the tax will never apply to it, it is also clear as an empirical matter that many trusts will never be affected. Moreover, those subject to the tax are taxed on a rational basis that relates to the amount of generation-skipping transfers actually made.

b. Allocation of the Credit While the Grantor Is Alive.

The allocation of the credit is perhaps the most difficult of the problems posed by the recommended system. The Reporters considered, and rejected, two alternative allocation conventions while the Grantor is alive. The first was to deny the credit. If the credit is not available, completed transfers will be subject to tax when made

by the Grantor and then again when property is distributed from the trust. For example, if A created a trust to pay income or principal to unrelated party B for his comfortable maintenance and support, with discretion also to make distributions to the children of B (all of whom are less than 35 years younger than A) for educational purposes, any distribution to B would be taxable at the 50 percent rate. The same would be true with respect to distributions to B's children. On the other hand, if A had not created the trust and had simply made transfers to B and B's children, (or if A had created Owned Trusts), only one tax would be imposed. It is clear, therefore, that denial of the credit would adversely affect the use of discretionary trusts for non-family members.

The second alternative was to permit elective use of the credit by the Grantor on an annual basis. The model for this alternative is the pre-1977 gift tax specific exemption. Under this alternative the trustee of any affected trust would have to inform the Grantor of the tentative tax liability of the trust and the Grantor would in turn notify the trustee of the amount of the credit he wished to allocate to the trust. Again the trustee would send a copy of the trust's tax return to the Grantor so that the Grantor

would have a record of the remaining credit amount.¹¹ The Reporters and Consultants agreed that this alternative was too complicated to justify its use.

c. Allocation of the Credit After the Death of the Grantor.

The Reporters and Consultants agreed that the Grantor should be able to allocate the unused credit as desired and that the trustees of any affected trusts should not be denied the opportunity to agree upon an allocation in the absence of Grantor action or to reallocate any credit initially allocated by the Grantor. In other words, after the death of the Grantor, the remaining credit is freely transferable by the trustees of any affected trust.

There was, however, some disagreement as to how the credit should be initially allocated in the absence of Grantor action. All conceded that the proposed allocation rule could create administrative problems because it would require the valuation of assets held by trusts that are not included in the Grantor's gross estate. Some argued, therefore, that the pre-death rule of applying the credit on a first in time basis should continue after death. The difficulty with this alternative, however, is that it creates unnatural pressures on a trustee to distribute property early in order to take advantage of the credit. On balance, given the fact that the Grantor may avoid these

¹¹ The ability of the grantor to affect the size of the corpus through decisions on the use of the credit would have to be specifically excluded from the scope of §§2036 and 2038.

problems by a specific allocation of the credit and that the trustees may, in any event, agree upon an allocation of the credit, the Reporters believe their recommendation is superior to the alternative.

d. Unused Credit of Spouse.

The Reporters do not recommend that the unused credit of a spouse of a Grantor be available to Non-Owned Trusts created by a Grantor.

The current transfer tax continues to treat spouses as separate transfer tax taxpayers despite the fact that most inter-spousal transfers are now tax-free. In the estate tax, the unused credit of one spouse is not available to offset deathtime transfers made by the other. The Reporters recognize that spouses can utilize the credit of both through planned tax-free interspousal transfers followed by transfers to trusts by the donee spouse. However, until the spousal unit is treated as a separate taxpaying unit for all purposes of the transfer tax, it does not seem appropriate to create an automatic spousal skipping tax credit of \$834,000. Moreover, such a rule would be inconsistent with the earlier recommendation to deny gift-splitting to Non-Owned Trusts.

5. When A Taxable Termination Occurs.

a. The Need For A Taxable Termination Rule.

The Taxable Termination rule is necessary to prevent undue deferral of an estate tax on property placed in trust. Under the Reporters recommendations a Taxable Termination

occurs in two situations. The first is when a trust is created that has beneficiaries assigned to generations and some of those beneficiaries are not members of the Excepted Class. In those circumstances, a Taxable Termination will occur at the termination of the last Interest of the last beneficiary assigned to the highest generation of beneficiaries not included in the Excepted Class, but only if the trust continues beyond that date. The second situation involves trusts that have beneficiaries who are not assigned to generations (in general, trusts for the benefit of non-family members). In this case, a Taxable Termination will generally occur at 35 year intervals if the trust continues in existence.

The Reporters considered, and rejected, imposing a Taxable Termination on trusts at the termination of the last Interest of the last beneficiary assigned to the generation immediately below that of the Grantor. The rule rejected by the Reporters would have treated the expiration of the interest of S as a Taxable Termination in a disposition in which Grantor, G, created a testamentary discretionary trust for the benefit of G's son S and the issue of S with the remainder to be distributed to the grandchildren of S at the death of the last surviving child of S alive at the date of G's death.

Treating the expiration of the Interest of S as a Taxable Termination would have two effects. First, it would accelerate the tax on distributions to the children of S

(the children of S would thereafter become members of the Excepted Class with the result that subsequent distributions to them would not be Taxable Distributions). Second, the tax would be collected on a tax inclusive basis with the substantive effect of increasing the tax rate on distributions to the children of S from $33\frac{1}{3}$ percent to 50 percent. If such a rule were implemented, Grantors would be induced to layer dispositions in trust to avoid the increased tax imposed on a Taxable Termination as opposed to a Taxable Distribution. An inducement to layer inevitably creates undesirable pressure on drafting techniques.

The Reporters believe that treating the death of S as a Taxable Termination would violate the neutrality principles their recommendations seek to implement. Under their recommendations, all distributions to the children (or grandchildren) of S are Taxable Distributions. Thus, if the trust is viewed as a transferor in an intervening generation a tax is collected (on a gift tax basis) on all generation-skipping distributions. Moreover, so long as a tax is collected on all trust distributions deferral is not a problem. However, an estate tax substitute must be imposed on transfers that can occur after it is no longer possible to view the Non-Owned Trust as an intermediate generation transferor. The time this occurs is, as the Reporters recommend, the termination of the last Interest of the last beneficiary assigned to the highest generation below the Excepted Class.

Where there is no beneficiary assigned to a generation, a 35 year period has been selected as the appropriate interval to impose an estate type tax.

b. Definition of Interest and Beneficiary.

The Reporters considered treating a power holder as a beneficiary but concluded that it was unnecessary. If a Grantor transfers property to a trust in which a child of the Grantor has a discretionary power to allocate income or principal among grandchildren, all distributions will be taxable whether or not there is a power holder in a higher generation.

c. Nominal Beneficiary Rule.

The nominal beneficiary rule is necessary to prevent undue deferral of estate tax through the use, as measuring lives, of beneficiaries assigned to generations who were never intended to receive distributions from the trust.

6. Consequences of Taxable Termination.

a. The Tax Base For Taxable Terminations.

As a Taxable Termination is designed to introduce periodic imposition of estate tax, the tax base is the entire undistributed corpus of the trust. However, distributions may either be triggered by the event which causes a Taxable Termination or be made at or about that time. The question, therefore, arises as to whether a distribution occurring at the time of a Taxable Termination should be treated as a Taxable Distribution or as part of the Taxable Termination base. The Reporters recommend the former result. Moreover, they recommend that

any distribution which is made within nine months of a Taxable Termination also be treated as a Taxable Distribution. The amount of such Taxable Distributions, together with the transfer tax paid on such distributions, would be deducted from the Taxable Termination tax base.

The following example illustrates the need for the rule that Taxable Distributions take precedence over Taxable Terminations. Assume a trust for the benefit of A, B and C, who are not members of the Excepted Class, with one third of the \$900 corpus payable to each at a specified age. The trust distributes \$200 to each of A and B when they reach the specified age, retaining \$100 to pay the tax on the transfer. If the distribution to C were treated on tax inclusive (estate tax) basis, C would receive only \$150. Defining the distribution as tax exclusive permits C to be treated the same as A and B. Moreover, treating all distributions on a tax exclusive basis and permitting a nine month grace period eliminates incentives to distribute property prior to a Taxable Termination. Since the Taxable Termination rule is designed to avoid drafting manipulation and to assure periodicity, the result is acceptable.

b. Allocation of Credit After a Taxable Termination.

The Reporters recommend that the amount of Generation-Skipping Tax Credit originally allocated to a trust be restored after a Taxable Termination. In addition, the trust's Generation-Skipping Tax Credit will be increased by the amount of any credit originally allocated to other Non-

Owned Trusts created by the same Grantor and subsequently transferred to the trust. This rule is necessary to provide neutrality in the choice between the creation of a single trust or multiple trusts for the same beneficiaries. For example, assume a testator creates a single discretionary trust for the benefit of A, B, C, D, E and F with one half the corpus distributable to B and C per stirpes at the death of A, the balance to remain in trust for the benefit of D, E and F until the death of the survivor. A, B, C and D are grandchildren of the testator. E and F are great-grandchildren of the testator. The trust that continues for the benefit of E and F after the death of D would have a \$417,000 credit. The same result should occur if, instead, the testator had created two trusts; Trust 1, a discretionary trust for the benefit of A, B and C until A dies, remainder to B and C per stirpes and Trust 2, a discretionary trust for the benefit of D, E and F until the death of the survivor with remainders over. The testator allocates \$208,500 of credit to each trust. Under the suggested rule, at the death of D after A, Trust 2 continues with a new \$417,000 credit. When A died and Trust 1 was distributed, any unused skipping tax credit originally allocated to it was transferred to Trust 2. The full amount of the skipping tax credit originally allocated to Trust 1 is available to Trust 2 after D's death.

c. Transfers Occurring After a Taxable Termination.

After a Taxable Termination, the Excepted Class will include beneficiaries assigned to the generation that is two below that of the generation of the youngest generation of beneficiaries assigned to the Excepted Class prior to the Taxable Termination. This result follows from the fact that the Taxable Termination is the equivalent of a testamentary transfer by the next higher generation.

7. Deduction For Income Tax of Beneficiary.

In an ideal tax system, assuming a trust and beneficiary are taxed on income at the same marginal rate the combined income and transfer taxes on a Taxable Distribution should be the same whether the trust first pays income tax on its income and makes a net gift of the balance or distributes the gross income net of the transfer tax payable on account of the distribution and the beneficiary pays income tax on the amount received. However, under current law, and the current version of the A.L.I. Subchapter J Project, a Non-Owned Trust is given an income tax deduction (to the extent of trust distributable net income) for distributions to beneficiaries who are then subject to income tax on the distribution. To the extent this occurs, the net benefit to the beneficiary of a distribution is reduced by the beneficiary's income tax liability. If, therefore, the amount of the taxable transfer made by the trust is measured by the gross amount transferred to the beneficiary the transfer is overvalued by the amount of the

beneficiary's income tax liability and the aggregate amount of tax collected is too high.

This overpayment of aggregate tax may be rectified in part by allowing the trust a transfer tax deduction equal to the income tax paid by the beneficiary on account of the Taxable Distribution, by allowing the trust an income tax deduction equal to the transfer tax paid by the trust on account of the Taxable Distribution, or by allowing the beneficiary an income tax deduction equal to the transfer tax paid by the trust. The Reporters recommend the first alternative.

The reasons for this preference are illustrated by the following examples. Assume a trust with \$300 of taxable income. Both the trust and the beneficiary are in a 50 percent income tax bracket. The trust distributes \$200 to the beneficiary. The beneficiary has \$200 of taxable income and the trust has \$100 of taxable income. The beneficiary pays \$100 in income tax and the trust pays \$50 in income tax. Since the trust now has only \$50 of income left, that must be its transfer tax liability unless it is to be required to use corpus to pay the transfer tax attributable to the distribution. At a 50 percent transfer tax rate, the trust's taxable transfer must be \$100. Since the trust has actually distributed \$200, a \$100 deduction is necessary to reach the correct taxable transfer. \$100 is, of course, the beneficiary's income tax liability. This result will occur only if the trust and the beneficiary are in the same income tax bracket. If the beneficiary is taxed at a higher rate

than the trust the deduction is overstated, and vice versa.¹²

Alternatively, the beneficiary could receive an income tax deduction equal to the transfer tax paid on the distribution by the trust. Using the same example, if the trust distributed \$133.33 to the beneficiary, it would incur a transfer tax of 66.67. The beneficiary would have taxable income of \$66.67, pay tax of \$33.33 and receive \$100 net of tax. However, the trust would have taxable income of \$166.67 and would have to pay income tax of \$83.33. Thus the aggregate tax is \$183.33 compared to \$200 if the trust had paid tax on the income and made a net transfer of the balance. The foregoing shows that even if the trust and beneficiary are taxed at the same income tax rate, an income tax deduction for the beneficiary does not produce the same aggregate result as would occur if the trust were taxable on all the income.

The final alternative, an income tax deduction at the trust level for the portion of the trust's transfer tax attributable to Taxable Distributions, works well when not all the trust income is distributed. Again, using the same

¹²These problems would not occur if all trust income were taxed to the trust (the rule applicable to individuals and the rule the Reporters prefer as the Subchapter J result for Non-Owned Trusts). The trust would have \$150 left after payment of income tax to distribute to the beneficiary. The trust would distribute \$100 to the beneficiary and would retain \$50 to pay the transfer tax on the distribution. The beneficiary would receive the \$100 free of income tax. The total tax would be \$200.

example, if the beneficiary is taxable on the trust distribution and we seek to leave him with \$100 after tax, he must receive a distribution of \$200. This means that the trust will have taxable income of \$100 but it cannot pay any income tax without invading corpus if it has paid \$100 of transfer tax. The result is reached by allowing the trust an income tax deduction for the \$100 of transfer tax it paid. The \$100 deduction reduces its taxable income to 0 and eliminates any income tax liability.

However, the foregoing rule achieves the proper result only if the transfer tax paid by the trust equals or is less than the trust's taxable income after the distribution deduction. The income tax deduction for transfer tax paid does not benefit the trust to the extent the deduction exceeds trust taxable income after the distribution deduction. An adjustment to the trust's transfer tax liability based on the transferee's income tax liability with respect to the excess distribution would be required to reach the proper result in such cases. Alternatively, the excess deduction could, to the extent attributable to distributed income, be carried forward indefinitely or distributed currently to the beneficiary. Since it is common for trusts subject to this rule to distribute all income, the Reporters concluded that the mechanism necessary to accomplish the proper result was too cumbersome.

Unless the actual income tax liability of the beneficiary is known to the trustee, and the trust and the beneficiary are in the same income tax bracket, aggregate

tax mismeasurement cannot be rectified completely. Since the Reporters do not believe that requiring a beneficiary to report to a trustee the income tax liability attributable to a trust distribution is either prudent or practicable, an arbitrary rate must be selected. The Reporters have no special expertise in selecting this rate. If it could be determined, the average marginal income tax rate of trust beneficiaries might be appropriate.

8. Repeal of Sections 2514 and 2041

Under the structure proposed by the Reporters, sections 2514 and 2041 are no longer necessary. The Owned Trust rules treat the holder of an absolute non-lapsing right to withdraw corpus as the Owner of the trust corpus. In all other cases, the Reporters believe the Non-Owned Trust rules provide appropriate transfer taxation of property subject to a power of appointment.

Under current law, wealthy grantors can give a general power of appointment to less wealthy relatives who will not exercise the power. Moreover, the amount subject to the power can be fine tuned to equal the unused portion of the less wealthy relative's unified credit. Treating the less wealthy relative as the owner of the property subject to the power would invite shopping for such individuals to proliferate skipping credits. The Reporters see no need to encourage this type of avoidance.

Owned Trusts1. When A Trust Is An Owned Trust.a. Marital Deduction Transfers.

A spouse of a Grantor will be treated as an Owner only if the transfer in trust qualifies for the marital deduction under current law. Moreover, the consequences of ownership will continue to be governed by current gift and estate tax law. Alternatively, dispositions as to which the spouse of the Grantor is treated as the Owner under the Owned Trust rules could qualify for the transfer tax marital deduction because the transferred property will be included in the transfer tax base of the transferee spouse. The latter result would require amendments to §§2056 and 2523.

b. Absolute Non-Lapsing Right to Withdraw.

The Reporters have chosen to treat a beneficiary as Owner only when he possesses an absolute non-lapsing right to withdraw because lapsing powers, or other powers which do not meet the definition, create significant opportunities to shift the incidence of tax without any realistic prospect that the power will be exercised. The Reporters recognize that this rule would permit individuals to have significant control over property without transfer tax consequences with respect to their own tax bases. But the cost cannot be more serious than the single bracket ride permitted by the Non-Owned Trust rules. The benefit is the avoidance of gaming through the selection of multitudes of low bracket taxpayers who are given lapsing powers.

c. Other Interests.

The Reporters' recommendations treat a beneficiary as the Owner of a trust even though the beneficiary may never receive a distribution of income or principal (as long as the trustee has the power to pay or apply to or for the benefit of the beneficiary) and even though the beneficiary does not directly or indirectly control the disposition of the trust assets upon the termination of the beneficiary's interest in the trust. Note also that the beneficiary is treated as the Owner of the trust corpus even though under current income tax law that beneficiary may not be taxable on undistributed trust income.¹³

Considerable thought has been given to the possibility that the beneficiary's interest in such a trust will be considered too tenuous to support treating the beneficiary as the owner of any portion of the trust. The Reporters have also considered, after extensive discussion in the Tax Advisory Group, the possibilities that the suggested rule would invite the very "owner-shopping" they seek to avoid in the preceding rule and that this rule puts too much pressure on identifying nominal beneficiaries. The Reporters have decided to continue to recommend the rule as described.

¹³The Reporters believe it would be desirable to treat all the income of an Owned Trust in which the grantor has not retained a reversion as taxable to the beneficiary, whether or not distributed.

The objections of some of the members of the Tax Advisory Group could be met by restricting Owned Trusts to trusts in which (a) the beneficiary is entitled for life to current distributions of the income of the trust and no other person can dilute that income interest by directing the distribution of corpus to another, or (b) the income may be paid currently or accumulated for the benefit of the beneficiary only and the beneficiary, alone or conjunction with another, has the power to direct the distribution of the corpus and accumulated income.

An alternative would treat a beneficiary as Owner of that portion of the trust from which income must be paid currently to the beneficiary (e.g. income requirements such as those in §2056(b)(5)). Under this alternative, a much smaller class of trusts would qualify as Owned Trusts. Because of the current income distribution requirement, trust income would be taxed to the beneficiary with respect to the portion the beneficiary is treated as owning. However the Reporters believe that the class so described is too narrow. The fact that the income from a specific portion of trust corpus cannot go to any person other than the beneficiary unless the beneficiary consents is, in their view, sufficient to require the beneficiary to be treated as the Owner of that portion.

2. Extent to Which Beneficiary Is Treated As Owner.

This rule avoids the uncertainty and complication of computing the share of corpus relating to an income interest stated in terms of a fixed amount.

The Reporters have considered and rejected suggestions that multiple beneficiaries be permitted to elect to be treated as pro rata Owners of the trust corpus in existence when their interest terminates and as pro rata transferors of any transfers which require the consent of other beneficiaries. This rejection is based on the following. Elections inevitably involve planning and administrative costs. They introduce gaming possibilities. They require information exchange. They create "deemed events." They must be carefully designed to avoid abuse and therefore tend to be complex. The appropriate person to make the election and the time within which it is to be made must be selected. Decisions must be made regarding whether an election is revocable and if so, the circumstances under which it can be revoked. In short, elections are complicated.

3. Transfer From Trust During the Life of the Owner.

a. Transfer of Income Interest By Owner.

The transfer of all or any part of an income interest is treated as a gift of the value of the income interest transferred. The Reporters recommend this result to permit the Owner to make subsequent gifts without having the Owner's adjusted taxable gift base automatically increased by the value of the corpus to which the income interest related. However, the Reporters recommend that the Owner be permitted to elect such a result if desired so long as the

Owner has transferred the entire income interest and has retained no rights to, or power over, the corpus of the trust.

The Reporters also recommend that transfers of income interests that cannot be valued using generally accepted valuation methods be treated as incomplete until the transferee actually receives distributions. This rule is designed to avoid the measurement difficulties associated with valuation of the portion of the corpus to which the transferred income interest relates and to minimize avoidance opportunities.

b. Consequences of Failure to Request Reimbursement.

The Owner is given a right of reimbursement for the gift tax attributable to the transfer. The question arises whether the Owner's failure to exercise this right should be treated as an additional gift. The logical consequence of treating the beneficiary as Owner is that the trust corpus "belongs" to him and remains as part of his transfer tax base. The reimbursement right is simply a mechanical tool to permit the Owner to get the funds from the trust if he desires to use them to pay the tax. Therefore the failure to exercise the reimbursement right is not an additional gift.

4. Termination of the Interest of the Owner at Death.

a. Estate's Right to Reimbursement.

The death of an Owner will result in the inclusion in the transfer tax base of the Owner of the portion of the

trust the Owner is treated as owning. The Owner's estate will be entitled to reimbursement for the transfer tax attributable to the inclusion of the trust corpus on an incremental (difference in tax liability attributable to inclusion) basis. Incremental reimbursement is recommended because it permits an Owner to dispose of assets owned outright without having to reduce bequests to account for the inclusion of the trust property. For example, if an Owner does not have a taxable estate in his own right and is the life beneficiary of a trust with remainders over to unrelated parties, the inclusion of the trust results in the transfer tax liability. The incremental reimbursement rule would permit the Owner to dispose of his own assets unreduced by the tax attributable to assets he constructively owns but cannot dispose of.

5. Nominal Owners.

A nominal owner rule is necessary to prevent grantors from seeking "owners" in lower transfer brackets.

6. Relief Provision For Too Frequent Imposition of Tax.

The reason for the distinction as to the availability of the credit based on generation assignment is best illustrated by a comparison of two situations. In Case 1, G transfers property to a discretionary trust for the benefit of G's children A, B, C until the death of the last survivor, remainder to G's grandchildren per capita. In Case 2, G transfers property in trust to pay income to A for

life, then to B for life, then to C for life, remainder to G's grandchildren per capita. Case 1 is governed by the Non-Owned Trust Rules. Under those rules, a tax is imposed with respect to the interests of A, B and C only when the property is transferred in trust and the trust property will be in the tax base of the members of the A, B, C generation only to the extent distributed to them and unconsumed by them. (Taxation at the death of the last survivor of A, B and C through the Taxable Termination device has not been recommended. See pages 78-80.) Without a full §2013 credit, the trust corpus in Case 2 would be fully taxable at the death of each of A, B and C under the Owned Trust rules. Thus, three full taxes could be imposed in a single generation. A §2013 credit without phase out is necessary in order to avoid further forcing dispositions into a mold that will be governed by the Non-Owned Trust rules.

The Reporters note that this suggestion has broader implications for the estate and gift tax in general. While the specific proposal was necessary to equalize somewhat the tax burden on Non-Owned and Owned Trusts, it raises the issue whether the §2013 credit should be universally available without phase out for transfers to individuals in the same or higher generations than the decedent. It also raises the question whether, in light of the post 1976 unification of the rate schedule, the creditable tax should be limited to estate tax.

7. Election To Be Treated As A Non-Owned Trust.

Despite the Reporters' aversion to elections, they are persuaded that one is appropriate in this case. The reasons are illustrated by the following. The Non-Owned Trust rules permit an individual to create one additional transfer tax taxpayer. If a Grantor has only one child, the Grantor for non-tax reasons might want to create a trust for that child that meets the definition of an Owned Trust. At the same time, the Grantor might not want to sacrifice the opportunity to create one additional transfer tax taxpayer. The Reporters see no reason to force the Grantor to create a trust that does not meet the Grantor's non-tax objectives. Accordingly, they recommend the election set forth above. However, in order to assure that property for which a marital deduction was allowed is included in the transfer tax base of one of the spouses, the election cannot be permitted where the original transfer qualified for the marital deduction.

Surtax on Outright Skips1. Imposition of Surtax.

Many believe that the policy goals of horizontal equity and neutrality require that there be no difference in the aggregate tax burden borne by a transfer of property outright through succeeding generations and the transfer of property directly to, or in trust for, the benefit of a member of a generation more than one generation below the transferor.

The Reporters recognized at the outset that there is severe disagreement between those who believe outright generation-skipping transfers should be subject to tax and those who do not. This disagreement was reflected by the Consultants 6-4 vote in favor of taxation. The Reporters initially sought to accommodate these conflicting views by identifying the situation that concerns most people, lineal familial transfers. The Reporters therefore proposed one method to achieve approximate neutrality, a deduction for property passing to a child of the grantor. For those concerned about untaxed generation-skipping transfers, approximate neutrality was achieved. Those who did not think there is a problem might have been satisfied with the fact that transfers to children would be tax preferred.

In discussing the proposed deduction for property passing to a child, the Reporters made several points. First, the desired neutrality result can be achieved either through a deduction for transfers to younger generations or a surtax on transfers that skip generations. This is illustrated for testamentary transfers that skip a single

generation by the following example. Assume that T, T', S and S' and are all in a 50 percent marginal transfer tax bracket. T dies leaving 100 to S who dies and transfers the remaining amount to GS. S receives 50 from T and GS receives 25 from S. T' dies leaving 100 to GS'. Acceptance of the neutrality principle dictates that the transfer by T' be taxed at a 75 percent rate, or a surtax of an additional 25 percent on the gross transfer made by T'. Alternatively, if T were granted a deduction equal to 40 percent of the property transferred to S and S in turn were granted a deduction equal to 40 percent of the property transferred to GS, T would incur a tax of 30 on a transfer of 100 leaving 70 to S who would incur a tax of 21 on a transfer of 70, leaving 49 to GS. In both cases GS and GS' receive virtually the same amount.

Second, recognizing that there are two routes to achieve neutral treatment does not end the matter. A choice must be made as to which is preferable. A deduction would reduce aggregate tax receipts, probably in a significant amount. Therefore, if revenues are to be maintained tax rates would have to be increased.

Finally, the question arises whether the system should attempt to provide neutrality along generational lines or whether it should be confined to lineal family transfers. A surtax on direct generation-skipping transfers or a deduction for all transfers to members of the generation immediately below that of the grantor makes the tax cost of

a direct transfer to a grandchild more expensive than a transfer to a collateral relative in the next generation. Many feel that result is unacceptable and that transfers to grandchildren should be no more costly than transfers to collateral relatives in the generation immediately below the transferor. The Consultants debated this question extensively and, by a vote of 6-5, indicated that they preferred to achieve generational neutrality.¹⁴ The Reporters preferred to achieve lineal neutrality and consequently, retained a deduction for transfers to children in the material presented to the Tax Advisory Group. However, the Tax Advisory Group, by a significant majority vote, indicated its view that generational neutrality was the appropriate goal and that a surtax was the appropriate method to achieve that goal. Accordingly the current recommendations contain a Surtax on Outright Skips.

Under the system proposed earlier, any distribution from a trust to a beneficiary not assigned to the same, a higher or next generation below the grantor is subject to a tentative tax. If direct transfers to members of generations more than one below the grantor are not subject to an additional tax, an incentive is created to use that form of disposition even though non-tax considerations might dictate otherwise. Thus, the Surtax on Outright Skips can be viewed

¹⁴The answer to this question also affected the Consultant's view of which route to neutrality was preferable. If neutrality for lineal transfers was the goal, the deduction was preferred by a margin of 8-2. If generational neutrality was the goal, a surcharge was preferred by a margin of 9-1.

as a backstop to the system proposed with respect to dispositions in trust. The Surtax satisfies those who believe it is necessary to eliminate any tax push against the use of Non-Owned Trusts and it enhances equity by assuring that inter-generational property transfers will bear similar tax burdens no matter the form of the original disposition. Those who argue that the amount of Outright Skips is de minimus ought not to be concerned. If they are correct, the Surtax will rarely apply. If they are not correct, that very fact will justify the existence of the Surtax.

Some have asserted that the imposition of the Surtax at the time of the direct transfer results in a higher tax burden on direct skips when compared to trust distributions to identical recipients because, in the latter case, the tax is postponed until the distribution is made. This assertion is incorrect so long as both the trust and the recipient are in the same income tax bracket. To illustrate, assume that X has the choice of transferring \$1,000,000 to grandchild Y outright or in trust to be distributed to Y in 30 years. For purposes of simplicity assume further that the surtax rate is 50 percent and that the property will quadruple in value over the 30 year period. If X transfers the property outright, a 50 percent tax is paid immediately, leaving \$500,000 which grows to \$2,000,000 at the end of the 30 year period. If X transfers the property in trust, no tax is paid immediately. At the end of 30 years, the trust

corpus is \$4,000,000 and, upon payment of a 50 percent tax, \$2,000,000 is distributed to Y. In either case, Y receives \$2,000,000. Put differently, there is no advantage to tax deferral if substantively equivalent dispositions are compared and the after tax rate of growth of the transferred property is the same in the hands of the ultimate transferee and a trustee holding the property for his benefit.

2. Outright Skip Defined.

a. Outright Skips To Individuals Assigned to Generations or Owned Trusts Owned by Such Individuals.

The Reporters recommendations do not attempt to impose a double Surtax on transfers that skip more than one generation. The Reporters considered an additional Surtax on outright multi-generational skips but concluded it would be an unnecessary complication.

First, the first generation skip creates the largest equity and neutrality problem.¹⁵ Second, existing empirical evidence suggests that very little property is transferred in a way that skips more than one generation. To the extent a member of an intervening generation is a beneficiary of a trust, the rules regarding Owned and Non-Owned Trusts subject transfers to tax. Finally, the Reporters do not believe that many double generation skips will occur. To accomplish that result, a Grantor would have to create an Owned Trust for or make an outright transfer to

¹⁵See page 114.

great grandchildren, a disposition that, in the Reporters' experience, does not happen.

b. Outright Skips To Individuals Not Assigned To Generations Or Owned Trusts Owned By Such Individuals

The Tax Advisory Group indicated a clear preference for applying the Surtax on outright transfers to individuals (or Owned Trusts owned by such individuals) who were not assigned to generations only if such individuals were more than 35 years younger than the Grantor.

c. Transfers To Entities Other Than Non-Owned Trusts Treated As Outright Skips

The Reporters recommend that any transfer to an entity other than a Non-Owned Trust be treated as an Outright Skip. The reasons for this rule are the same as the reasons advanced at page 69 regarding Taxable Distributions to entities. The Surtax could be avoided if a transfer to an entity owned by the transferor's grandchildren was not an Outright Skip. If such individuals owned only a part of the transferee entity the determination of the amount of the Outright Skip would be difficult. If no individual assigned to a generation other than the generation below that of the Grantor or no individual who was not assigned to a generation and was not more than 35 years younger than the Grantor, owned any part of the entity, the Surtax should not, in theory, apply. However, verification of the identity of the owners of an entity and, where necessary, their ages would required burdensome and potentially unenforceable information exchange.

3. Amount of Surtax.

The question of the amount of the Surtax is difficult. The aim is to assure that approximately the same tax is paid with respect to outright and inter-generational wealth transmissions. The problem is that the "correct" tax rate upon which to determine that equivalence is unknown because the marginal tax rate applicable both to the initial transfers and to the imputed transfer by a member of the intervening generation is unknown. If a grantor with net assets of \$5,000,000, one child and one grandchild transfers property directly to a grandchild it may be appropriate to assume that if the property had been transferred to the child and the child had then transferred the property *intervivos* to the grandchild a 50 percent tax would have been imposed on both transfers. On the other hand, it would not be appropriate to assume that result if both the grantor and the child possessed aggregate wealth of less than \$2,500,000. Thus, any method to determine the amount of the Surtax must be somewhat arbitrary.

The Reporters have chosen to determine the amount of the Surtax by assuming that any Grantor of an Outright Skip had instead transferred an amount equal to the value of the property that was the subject of the Outright Skip to a Non-Owned Trust which immediately thereafter transferred that amount in a Taxable Distribution to the actual transferee. As indicated at pages 59-61, this leads to a different Surtax amount depending upon whether the Outright Skip occurs during the life or at the death of the Grantor.

However, it has the virtue of eliminating any tax difference between outright and trust dispositions.

The following is the proof of the Surtax amounts determined in the examples at pages 60-61.

a. Outright Skips That Are Gifts.

The Surtax on a \$1,000,000 transfer by gift to a grandchild of a Grantor in the 50 percent marginal transfer tax bracket was \$750,000 if the Grantor had previously used his entire Generation-Skipping Tax Credit and \$124,500 if he had used none. Thus, when the gift tax on the transfer is added to the Surtax, the total transfer tax paid is \$1,250,000 if the Grantor had used his entire credit prior to the gift and \$624,500 if he had previously used none of his credit.

If a Grantor wanted to transfer \$1,000,000 to his grandchild through a Non-Owned Trust and he had previously used his entire Generation-Skipping Tax Credit, he would have to transfer \$1,500,000 to the trust which in turn would distribute \$1,000,000 to the grandchild. The Grantor would incur a gift tax of \$750,000 on the transfer to the trust and the trust would incur a \$500,000 tax on the \$1,000,000 Taxable Distribution. The total tax is \$1,250,000.

If the Grantor had used none of his credit he would transfer \$1,083,000 to the trust, which would incur a tax liability of \$83,000 on the \$1,000,000 distribution to the grandchild (the \$500,000 tentative tax liability on the \$1,000,000 Taxable Distribution is offset by the \$417,000 credit). The Grantor would incur a gift tax of \$541,500 on

the transfer to the trust. Thus the total tax is \$624,500.

b. Outright Skips That Are Transfers At Death.

The Surtax on a \$1,000,000 testamentary transfer to a grandchild by a Grantor in the 50 percent marginal transfer tax bracket was \$1,000,000 if the Grantor had previously used his entire Generation-Skipping Tax Credit and \$166,000 if he had used none. Since the estate tax is computed on a tax inclusive basis, the estate tax attributable to the \$1,000,000 transfer was \$1,000,000. Thus the total transfer tax liability for the Outright Skips occurring at death was \$2,000,000 if the Grantor had used his entire credit prior to death and \$1,166,000 if he had previously used none of his credit.

If a Grantor wanted to make a testamentary transfer of \$1,000,000 to his grandchild through a Non-Owned Trust and he had previously used his entire Generation-Skipping Tax Credit, he would have to fund the trust with \$1,500,000, which in turn would distribute \$1,000,000 to the grandchild. The estate tax on the \$1,500,000 transfer to the trust is \$1,500,000, and the trust would incur a \$500,000 tax on its \$1,000,000 Taxable Distribution. The total tax is \$2,000,000.

If the Grantor had used none of his credit he would direct a testamentary transfer of \$1,083,000 to the trust, which would distribute \$1,000,000 and pay a tax of \$83,000. The estate tax on the \$1,083,000 transfer to the trust is \$1,083,000. The total tax is \$1,166,000.

Appendix A

In preparation for the first Consultant's meeting, the Reporters examined existing literature to get a sense of when, historically, generation-skipping transfers were recognized as a transfer tax problem, the nature of the problem recognized, and the solutions proposed. This survey is set out in Appendix C.

The historical examination revealed that what has generally been referred to as "the generation-skipping problem" really involved two separate issues. The first, which does not necessarily raise issues of generation assignment, is whether the term "transfer of an interest in property" is defined properly in the transfer tax. The second, which does raise the issue of generation assignment, is whether a comprehensive system of transfer taxation requires provisions to assure that transfer taxation occurs at least as often as some defined regular interval.

The recognition that two separate issues were presented led the Reporters initially to focus not only on transfers which avoid tax in intervening generations, but to inquire more generally whether a problem is caused by the failure of current law to impose a transfer tax:

- (1) at the expiration of concurrent or sequential interests in property over which intermediate beneficiaries or power holders do not have interests sufficient to cause a transfer tax liability no matter what the generational relationship of the transferor to the beneficiaries or power holders, and

(2) as a subhead or independently, on transfers which skip younger generations.

For descriptive purposes in the material that follows, any transfer within the first category is called a "skipping transfer." A transfer within the second category is called a "generation-skipping transfer."

Part I. Criteria Used In Analyzing The Nature and Extent of Problems Relating to Skipping Transfers

One could approach the question whether skipping transfers pose a transfer tax problem by asking whether the opportunity to make tax-free skipping transfers is consistent with the objectives of the wealth transfer tax. The major difficulty with this approach is that apart from the obvious revenue objective, there has never been any clear consensus among academics, tax professionals or politicians, as to the objectives of the transfer tax. Rather, over the years a number of different themes have emerged in discussions over the objectives of a transfer tax: taxation of windfalls, taxation to reduce wealth concentration and taxation of the special ability to pay that is allegedly indicated by the very existence of property gratuitously transferred.¹ The taxation of property once a

¹C. Shoup, Federal Estate and Gift Taxes 100-101 (Brookings 1967) [hereinafter cited as "Shoup"].

generation is also a recurring theme.² If accepted as an independent objective of the transfer tax, it means that all generation-skipping transfers must be subject to tax.

Even if taxation of property once a generation is not accepted as an independent objective of transfer taxation, one must still face the question how often in the wealth transmission process tax should be imposed. The answer is not implicit in the statement of any other objective of the wealth transfer tax. For example, increased revenue needs may be met by raising rates and/or lowering exemption levels without expanding the scope of the tax to include skipping transfers. Wealth concentrations will be diminished if generation-skipping transfers are subject to tax; the tax would simply remove the tax preference accorded wealth dispersion among younger generations. However, the question may also be approached by asking whether tax free skipping transfers are consistent with the normative criteria commonly applied to taxes of any kind.

The normative criteria proposed for application in analyzing the skipping issue are:

1. Horizontal Equity. Similarly situated taxpayers should bear similar tax burdens with respect to

²Id. at 101; Jantscher, The Aims of Death Taxation, in E. Halbach, Ed., Death Taxes and Family Property: Essays and American Assembly Report 46 (West 1977).

events that fall within the scope of the tax. This principle is known as horizontal equity. Horizontal equity in a tax system described as an excise on wealth transfers has traditionally been tested only against the tax base.³ The implicit assumption has been that the existing system properly describes the taxable event as the transfer of an interest in property and, further, that interests in property are, by and large, properly defined.⁴

While this is a plausible way to test the application of the principle of horizontal equity, it may be unduly limited in scope because it does not examine the effects of the system beyond taxation of the transferor. A broader view of the concept of horizontal equity would seek to examine whether the process of wealth transmission

³Prior to unification of the transfer tax rate structure in 1976, there was an issue of horizontal equity involving the taxation of lifetime and deathtime transfers due to the separate exemption and lower rate schedule applicable to lifetime gifts. Since 1976 the issue is the disparate treatment arising from (a) the failure to include gift tax paid as part of the gift tax base for transfers occurring more than three years before death and (b) the size of the present interest exclusion.

⁴The principal area of dispute over the tax base has been the treatment of property subject to powers of appointment. The issue has been the extent to which the holder of a power of appointment should be treated as owning an interest in the property subject to the power. Under current law, the issue has been settled by treating the holder of a power as the owner of the underlying property when the holder has to power to benefit himself or his estate economically through exercise of the power and then, only if the exercise of the power is not subject to a statutory ascertainable standard, may be exercised without the consent of a party holding an adverse economic interest in the property or without the consent of the creator of the power.

from the original transferor to the ultimate recipient results in similar tax burdens no matter what form the original transfer takes.⁵ Under this view, horizontal equity is achieved when two conditions are met: (a) similarly situated transferors have borne similar tax burdens with respect to their transfers, and (b) the process of wealth transmission has resulted in similar tax burdens upon property received by the ultimate transferee. This broader concept of horizontal equity introduces the question of the necessity for a tax at each generation level.

2. Vertical Equity. The differentiation in the tax burden borne by those with different levels of wealth transfers is expressed by the progressive rate schedule applicable to cumulative transfers. There is no "absolutely correct" level of progressivity, but vertical equity, as expressed by the nominal rates of tax imposed by the progressive rate schedule, is affected if horizontal equity is violated. If horizontal equity is not achieved, the actual effective rate of tax on wealth transmissions varies from the nominal effective rate and the progressivity of the system is undermined.⁶

3. Neutrality. Any system of taxation should intrude as little as possible on non-tax decisions with

⁵See Andrews, "What's Fair About Death Taxes?," 26 Nat. Tax J. 465, 466 (1973).

⁶Viewing vertical equity as encompassing the burden of the tax borne by transferees may lead to an examination of an accessions tax.

respect to the allocation of resources. When applied to the wealth transfer tax, the concept of neutrality dictates that the tax structure should not favor one form of wealth transmission over another.

4. Administrability. The goal is to assure that the full range of economic costs of administration, planning and compliance are kept as low as possible consistent with the equity and neutrality objectives of the system. In assessing the administrability of any tax system, the full range of transactions costs must be taken into account. The direct costs to the government of administering the tax regime and to affected taxpayers in complying with it are obvious. Not so obvious, more difficult to quantify, but nonetheless important are other costs, such as professional fees incurred in planning to meet or minimize anticipated tax burdens, educational costs incurred in mastering the technicalities of the tax statute, and social costs associated with perceptions with respect to the "fairness" of the system. In addition, any change involves costs; professionals must re-educate themselves, affected taxpayers must review and possibly revise existing plans and administrators must adjust their collection and compliance operations. Recognition of these "start-up" costs are particularly important in assessing the advisability of any proposed change.

Part II. The Effects of Skipping Transfers

The characteristic common to all forms of skipping transfers is that ultimate ownership of transferred property passes to individuals separated from the transferor by an intervening beneficiary or power holder or, in the case of an outright transfer, by an intervening generation at the cost of a single transfer tax paid by the original transferor. Since this is the common characteristic of all forms of skipping transfers, analysis should commence with an examination of the consequences of the allowance in a tax on wealth transmissions of any skipping transfers.

For purposes of this analysis, one must assume a standard disposition against which the consequences of skipping may be compared. A simple one would be any outright transfer to X, who in turn transfers to Y. This standard, without regard to generation assignment, could be the benchmark against which all proposals are tested. However, there is very little in the way of empirical data relating to skipping transfers except as they relate to generation-skipping. Therefore, the balance of this discussion will be in terms of generation-skipping transfers, but it may very well be that the generation-skipping transfer is only a part of a larger issue.

If one addresses the question of generation-skipping transfers, the obvious standard is wealth

transmission directly from one generation to the next. For purposes of simplicity, the effects of single generation skips are compared at the outset. The effects of multiple generation skips are explored thereafter. Finally, these effects are quantified by an examination of existing empirical data and anecdotal evidence.

1. Horizontal Equity and the Single Generation Skip. Generation-skipping violates the principle of horizontal equity. This is simply illustrated. Assume a tax structure which taxes the first \$500,000 of transfers at 25% and the next \$500,000 of transfers at 50%. A with child B and grandchild C dies with \$1,000,000 of assets. If A leaves the \$1,000,000 net of tax to B, B receives \$625,000, if B in turn consumes the income from the fund and leaves \$625,000 net of tax to C, C receives \$437,500. A's original fund of \$1,000,000 has been reduced by \$562,500 or 56.25% by the imposition of successive transfer taxes. D, with same assets, leaves \$1,000,000 net of tax to a trust to pay the income to child E for life, remainder to grandchild F. F receives \$625,000. While the \$1,000,000 wealth of A and D is taxed identically at their respective deaths and the intervening generation beneficiaries, B and E, each receive the same benefit, the form of the wealth transmission results in C receiving \$187,500 less than F.

To be sure, B could have consumed the corpus of the \$625,000 fund. If one were to introduce that possibility into the analysis, D could assure that corpus is available to E by permitting E to withdraw corpus pursuant to an ascertainable standard, or permitting an independent trustee to distribute corpus to E. In other words, the transfers by A and D may be made in a way that treats the intervening generations identically in virtually all substantive aspects while preserving the differential in the amount received by the ultimate transferee.

2. Vertical Equity and the Single Generation Skip. The foregoing example shows that, under the given rate assumptions, the effective rate of tax paid on the A-B-C wealth transmission was 56.25 percent, while the effective rate of tax paid on D-E-F transmission was 37.5 percent. The generation skipping transfer is taxed at a rate that is 66.6 percent that of the outright transfer. Or put differently, the rate of tax on the outright transfer is 150 percent that of the rate on the generation-skipping transfer.

3. Neutrality. The opportunity to avoid tax through generation-skipping transfers creates an incentive to dispose of property in a tax minimizing manner. In other words, the neutrality principle is violated. All other things being equal, the use of trusts or annuity/remainder arrangements are tax preferred. This analysis contradicts the assertion that subjecting

generation-skipping arrangements to transfer taxation is a tax penalty. The use of a generation-skipping arrangement is not penalized. Rather, its advantages are eliminated. The tax system becomes neutral with respect to the selection of a form of wealth disposition.

4. Multiple Generation Skips. The same equity and neutrality issues exist where more than one generation is skipped. However, the relative advantage of multi-generational skips is less than that attained by a single generation skip. In other words, in relative terms, the greatest inequity is created by a single-generation skip. This occurs because the single generation skip produces the largest base erosion.

The proposition is demonstrated by the following excerpt from Professor Shoup's classic study, Federal Estate and Gift Taxes, in which it is assumed

that the estate tax base is a circulating fund of constant size and that generations skipped are of constant duration. Then, if all decedents leave all their property in trusts that skip only one generation, 50 percent of the estate tax base is lost. . . . If all decedents leave all their property in trusts that skip two generations instead of one generation, the estate tax base is one-third what it would be under no skipping, instead of one-half. The reduction in base, from what it would be under one-generation skipping, is from 50 to 33 1/3 (with 100 as the base under no skipping). This is a decrease of one-sixth (16 2/3 percent) of the base under no skipping. Three-generation skipping reduces the base from 33 1/3 to 25, or by one-twelfth of the base under no

skipping. Thus the big erosion occurs with one-generation skipping. Further skipping is proportionately much less serious.⁷

This analysis is sound in terms of base erosion. From the point of view of each generation, however, each skip is equally useful. Put another way, from the point of view of the ultimate transferee, removal of property from a 50% tax rate means that the transferee will receive twice as much property as he would otherwise have received.

5. The Empirical Data. If all transferors utilized generation-skipping arrangements to precisely the same extent, the equity issue would disappear and the neutrality issue would become moot. However, not all transferors utilize generation-skipping arrangements. Moreover, to the extent that generation-skipping arrangements are in fact utilized more extensively by wealthy transferors, horizontal and vertical inequity are even more pronounced than the disparity indicated by comparing transferors at equal wealth levels.

Empirical data on the extent to which generation-skipping arrangements are utilized and the duration of the arrangements that are created are at best sketchy. The findings of the most extensive, and most current, empirical survey of the extent and duration of generation-skipping transfers are set out in some

⁷ Shoup, supra note 2, at 33.

detail in Appendix B. The results of that survey, an IRS tabulation of estate tax returns filed in 1957 and 1959, are summarized in the following material.⁸

a. Lifetime Generation-Skipping Transfers. The IRS study found, not surprisingly, that lifetime giving was principally the domain of the wealthy. Only 10.1 percent of decedents with gross estates of less than \$300,000 ("small estates") made lifetime transfers and those transfers amounted to approximately 2.6 percent of total gross transfers (which for this purpose included charitable transfers and transfer taxes paid). Approximately 30 percent of decedents with gross estates between \$300,000 and \$1,000,000 ("medium estates") made lifetime transfers which amounted to approximately 4.3 percent of gross transfers. Approximately 54 percent of decedents with gross estates in excess of \$1,000,000 ("large estates") made lifetime transfers which amounted to approximately 6.1 percent of total gross transfers.

Of course, not all these gifts were in trust. Decedents with small estates transferred 3.5 percent of their gifts in trust (\$92,000 of a total of \$2,656,000). Decedents with medium estates transferred 8.0 percent of their gifts to trusts (\$2,948,000 of a total of \$36,890,000). Decedents with large estates transferred 28.5

⁸Unless otherwise indicated, the source for the material summarized is Shoup, *supra* note 2, at Chapter III and Appendices B and C.

percent of their gifts in trust (\$95,553,000 of a total of \$335,585,000).

Of the total of \$92,000 transferred in trust by decedents with small estates, \$82,000 (89 percent) was transferred to generation-skipping trusts. Of the total of \$2,948,000 transferred in trust by decedents with medium estates \$2,162,000 (73 percent) was transferred to generation-skipping trusts. Of the total of \$95,553,000 transferred in trust by those with large estates, \$82,171,000 (86 percent) was transferred to generation-skipping trusts. Of the total generation-skipping trust dispositions of \$84,415,000, \$62,413,000 or 74 percent were to trusts which skipped only a single generation.

These data indicate quite clearly that where trusts were used for lifetime transfers the disposition was most generally to a generation-skipping trust. Moreover, most generation-skipping dispositions skipped only one generation.

There is no empirical data regarding the extent of outright inter vivos generation-skipping transfers. However, since the data demonstrate that the wealthy make the most lifetime gifts, it follows that to the extent outright generation-skipping transfers are made, the wealthy are the transferors.

b. Testamentary Generation-Skipping Transfers.

The 1969 Treasury Department Tax Reform Studies and Proposals contain aggregate data on the amount of testamentary generation-skipping transfers made by decedents dying in 1957 and 1959. The following table is taken from the 1969 Studies:⁹

TABLE 1. Proportion of Total Noncharitable Transfers Skipping a Generation, By Estate Size and Type of Disposition

(Dollar amounts in millions)

Gross estate size (in thousands of dollars)	Gross transfers ¹ (1)	Transfer tax (2)	Noncharitable transfers (1-2)	Generation skipping transfers ²					
				Total	Not in trust		In trust		
				Amount	Per- cent of non-chari- table trans- fers	Amount	Per- cent of non-chari- table trans- fers	Amount	Per- cent of non-chari- table trans- fers
Under 300.....	\$4,574	\$219	\$4,355	\$410	9.4	\$158	3.6	\$252	5.8
300 to 1,000..	3,649	470	3,179	533	16.7	157	4.9	376	11.8
1,000 and over..	4,502	1,089	3,413	868	25.4	225	6.6	643	18.8

¹ Total value of noncharitable transfers made during life and at death plus the amount of transfer taxes paid.

² A special study prepared by IRS identified remaindermen of trusts as children, grandchildren, great grandchildren, other relatives and nonrelatives (as well as additional categories not here relevant such as charity, brothers and sisters, etc). Thus, the bequests to lineals could be clearly distinguished between generation skipping and others. For other relatives and nonrelatives it was necessary to look at dispositions to lineals to estimate the likely portion of bequests to other relatives and nonrelatives that were generation skipping. With regard to direct bequests to lineals the portion that was generation skipping was 5 percent below \$300,000, 10 percent from \$300,000 to \$1,000,000 and 15 percent above \$1,000,000. For trust remaindermen the portion generation skipping among lineals was 33 percent below \$300,000, 50 percent from \$300,000 to \$1,000,000, and 75 percent above \$1,000,000.

⁹U.S. Department of Treasury, Tax Reform Studies and Proposals 389 (1969) [hereinafter cited as "1969 Treasury Proposals"].

The table indicates that generation-skipping transfers as a percentage of gross transfers less transfer tax and charitable transfers increased as the size of the gross transfers increased. For small estates, approximately 9.4 percent of net non-charitable transfers were generation-skipping; for medium estates, the percentage was 16.7; for large estates the percentage was 25.4.

There is no further empirical data on the extent of outright testamentary generation-skipping transfers. However, the Internal Revenue Service tabulation of 1957 and 1959 estate tax returns was further analyzed by Robert Anthoine to determine the duration of in trust generation-skipping transfers.¹⁰ The results of his analysis are set forth in Table 2:

TABLE 2 - GENERATION SKIPPED AS PERCENTAGE OF TRUST CORPORA OF GENERATION-SKIPPING TRUSTS BY SIZE OF GROSS ESTATE, ALL DECEDENTS, SUMMARY BY SAMPLE STRATA, 1957 AND 1959 DECEDENTS COMBINED

Size of Gross Transfers	Percentage of generation-skipping trusts skipping			
	1 Generation	2 Generations	3 Generations	4 Generations
Small	85	13.4	1.6	—
Medium	84	10.9	5.1	—
Large	78.5	15.6	5.3	.6

The data indicate that, as with lifetime giving, testamentary generation-skipping transfers in trust principally skip a single generation. Due to the size of the sample, is not clear the extent to which multi-

¹⁰Shoup, *supra* note 2, at Appendix B.

generation skipping actually occurred in small and medium estates. However, since all millionaire decedents' estates in 1957 and 1959 were analyzed, the data on the number of generations skipped by the testamentary dispositions made by those decedents should be accurate and indicate that wealthier decedents make more use of multiple generation-skipping trusts than do less wealthy decedents.

The data are interesting from another perspective. As indicated earlier, the use of a properly structured trust may postpone transfer tax incidence until the expiration of the applicable limitation imposed by the rule against perpetuities. Yet when actual trust dispositions are examined, it appears that few testators made these tax minimizing transfers. Multiple generation-skipping did not often exceed two generations.

6. Anecdotal Evidence. It is, of course, dangerous to rely too heavily upon anecdotal evidence in analyzing an issue susceptible of empirical resolution. However, the fact remains that the 1957-1959 survey is dated. Thus, one must rely on the impressions of those who actually practice in the area to ascertain the extent to which the empirical data should be adjusted. Moreover, since Congress, in 1976, enacted Chapter 13 which imposed an excise on certain generation-skipping transfers, the most useful informa-

tion for purposes of determining the effect of generation-skipping on the transfer tax system is that relating to experience prior to 1977. Post 1976 experience is relevant to a different issue--the extent to which the 1976 amendments are effective in eliminating whatever problems are posed by generation-skipping.

A number of general points may be made. First, estate planning became more important in the years after 1959 due to the fact that a greater number of decedents had estates of sufficient size to be concerned with consulting a professional with respect to tax minimization techniques. Second, law schools developed specialized courses in estate planning, thus introducing new generations of lawyers to the tax benefits available through the use of generation-skipping transfers. Third, the growth of continuing professional education programs served to inform a wide range of practitioners at all levels of sophistication not only of the benefits of generation-skipping arrangements but also how to draft the instruments to achieve the desired result.¹¹

The combination of these circumstances does not necessarily lead to the conclusion that more

¹¹As just one example, since 1968 the Practising Law Institute has conducted 139 Seminars on estate planning and estate administration at various locations around the country.

generation-skipping than indicated by the Internal Revenue Service survey existed prior to the Tax Reform Act of 1976. It does, however, permit the observation that the technique probably became more widely known. In any event, if the testimony before Congress of acknowledged estate planning experts¹² is at all representative it is probable that its use by the "millionaire" class was at least as extensive after 1959 as before.

7. *Summary.* The skipping transfer has the potential seriously to erode the tax base. It appears that the problem is greatest in generation-skipping transfers which skip generations below the initial transferor of property. The data demonstrate that taxpayers do utilize skipping arrangements and that the use of those arrangements is principally by wealthy taxpayers. Relating the data to the equity criteria set forth in Part I of this Appendix indicates that a self-selected group of taxpayers have been able to effect a reduction of the tax burden borne by their wealth transmissions to ultimate beneficiaries when

¹²See, e.g., General Tax Reform: Panel Discussions Before House Ways and Means Comm., 93d Cong., 2d Sess. (1973) reprinted in Staff of Comm. on Ways and Means, Background Materials on Federal Estate and Gift Taxation, 94th Cong., 2d Sess. 69-182 (Comm. Print 1976); Federal Estate and Gift Taxes: Hearings Before House Ways and Means Comm., 94th Cong., 2d Sess. 1332-1447 (1976). See also, G. Cooper, A Voluntary Tax? 56-58 (Brookings 1979).

compared to the burden borne by wealth transmitted by that group of taxpayers who, for whatever reason, did not take advantage of this opportunity. Thus, the horizontal equity criterion is violated. Moreover, since the data show proportionately greater use of generation-skipping by wealthier taxpayers the result is to reduce the effective rate of tax on their aggregate transfers to a point approaching the burden borne by taxable intergenerational transfers of less wealthy taxpayers. Put differently, wealthier taxpayers are, through generation-skipping, reducing their aggregate effective rate of tax to that nominally applicable to wealth transmissions of considerably lesser amounts.

The data from the 1957-1959 study yield one other fact that is significant in assessing the extent of this problem. Single generation-skipping transfers constituted the bulk of generation-skipping dispositions. Since the foregoing has also demonstrated that the first generation skip is the major base eroding transfer, it indicates that solutions to the problem should focus on transfers which skip a single generation.

Appendix B

This Appendix contains a more detailed presentation of the data obtained in the Internal Revenue Service Tabulation of 1957 and 1959 estate tax returns. Part I, dealing with lifetime transfers, contains tables prepared by C. Lowell Harriss in Appendix C of Shoup, Federal Estate and Gift Taxes (Brookings 1967).^{*} Part II, dealing with testamentary transfers, is Appendix B from the same book. Appendix B was prepared by Robert Anthoine.

In the tables set forth below, the following definitions were used:

Trusts. The type of trust pertinent to this study is property for which the initial transfer (gift or bequest) is taxable, but no tax is imposed upon the termination of the tenancy. Following this concept, the amounts classified as trusts are transfers of real or personal property involving a tenant which is a different person or organization than the remainderman. Of course, there can be more than one life tenant and more than one remainderman.

This definition of a trust is both broader and narrower than the legal concept of a trust. It is broader in the sense that the transfer of certain property, notably real estate or life insurance, may involve a tenant and a remainderman--each a different person or organization--even though no true trust instrument exists. It is narrower in the sense that, even though a trust instrument exists, transfers where the same person or organization is both the tenant and the remainderman are excluded from this definition. Also excluded from the category of bequests in trust are those cases where the spouse was named as the life tenant if the bequest in trust qualified for the marital deduction (because, for instance, she was given a general power of appointment over the remainder). In this case there is no generation-skipping, since the bequest becomes part of the estate of the surviving spouse and is included in her gross estate.

Information for each bequest or gift in trust was tabulated separately, regardless of the number of trusts established by the decedent (or grantor).

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Trusts--duration. The duration of a trust refers to the number of generations (or a term of years, or both) represented by the trust income beneficiaries, before the trust is terminated and the corpus is transferred to the remainderman (remaindermen). It represents the number of generations of beneficiaries involved where no new gift or estate tax is payable on the cessation of the temporary interest and the succession of a new interest. Thus neither the grantor (donor or decedent) nor the remainderman is counted in determining the number of generations (duration) of a trust, but only the intervening trust beneficiaries.

Ten categories of "duration" are used in this study, ranging from "Trust for a term of years only" to "Trust for three generations and a term of years."

One-generation trusts are those with one tenant, such as the wife for life, or those with two or more tenants of the same generation, such as sons and daughters for life.

Two-generation trusts are those with tenants belonging to two different generations, such as (1) children for life and at their death to grandchildren for life, or (2) wife and son concurrently (the trust to terminate on death of son).

Three-generation trusts are those with tenants belonging to three different generations, concurrently or successively.

Trusts--life tenant (or tenant for a term of years). This is the person or organization that is entitled to enjoy the use of trust property or to receive the net income from a trust. If a power to invade the trust exists, the life tenant may also receive a portion of the corpus of the trust. For trusts in this study, the life tenant is a different person or organization than the remainderman. Of course, there can be more than one life tenant. Many types of tenants were classified separately.

Trusts--remaindermen. When the trust terminates, the remainderman is the person or organization entitled to receive the corpus of the trust. For trusts in this study, the remainderman is a different person or organization than the life tenant. (For instance, if a gift or bequest was made to "my son John, to receive the income until he reaches the age of 25, and then to receive the principal or corpus," the gift or bequest was regarded as "other than in trust," since there was no generation-skipping involved, and no avoidance of tax.) Of course, there can be more than one remainderman. Many types of remaindermen were classified separately.

Part I. Life-Time Transfers

In the surveyed estates below \$300,000 (Small Estate Size), approximately 10.1% of decedents had made lifetime gifts. Approximately 30% of decedents with estates between \$300,000 and \$100,000 (Medium Estate Size) had made lifetime gifts. Approximately 54 percent of those with estates in excess of \$1,000,000 (Large Estate Size) had made lifetime gifts. The data are summarized in Table 1.

TABLE 1. Gross Transfers at Death and During Life, All Decedents, 1957 and 1959
(Dollar amounts in thousands)

Estate size	Number of decedents	Total amount of gross transfers	Number of decedents making non-charitable transfers during life	Non-charitable gifts	Noncharitable lifetime gifts	
					Number of estates reporting	As a percentage of gross transfers
1957						
Small	398	\$46,333	40	\$1,147	10.0	2.5
Medium	876	403,544	263	15,311	30.0	3.8
Large	1,119	2,787,869	583	154,652	52.1	5.5
1959						
Small	471	\$56,318	48	\$1,509	10.2	2.7
Medium	968	461,536	299	21,579	30.9	4.7
Large	1,137	2,706,969	636	180,933	55.9	6.7

The data also indicate that among millionaire ("Large Estate Size") decedents both the number of decedents making lifetime transfers and the amount of those transfers as a percentage of total gross transfers increased as the gross estate increased. The following Table illustrates the magnitude of this increase:

TABLE 2. Gross Transfers at Death and During Life, Millionaire Decedents, 1957 and 1959 Returns Combined, Percentages

Size of gross transfers (In thousands of dollars)	Number of decedents in class as percent- age of all millionaire decedents	Amount of gross transfers in class as percent- age of total gross transfers	Noncharitable lifetime gifts	
			Estates reporting, as a percentage of total in class	As a percentage of total gross transfers
Under 900	4.4	1.2	28.3	3.7
900- 1,000	6.1	2.4	24.8	0.8
1,000- 1,250	23.2	10.7	43.6	2.7
1,250- 1,500	16.9	9.5	51.4	4.3
1,500- 1,750	10.5	7.0	55.1	5.4
1,750- 2,000	8.0	6.2	64.6	6.2
2,000- 3,000	14.1	14.2	61.5	5.9
3,000- 5,000	9.5	14.9	71.2	7.7
5,000-10,000	5.1	13.9	78.3	7.8
10,000 or more	2.3	20.2	92.3	7.5
Total	100.0	100.0	54.0	6.1

The same data were further analyzed with respect to the percentage of inter vivos dispositions made outright and in trust. Table 3 summarizes this data for all decedents and shows that, as a percentage of all gifts, the use of trust for inter vivos gifts increased as estate size increased.

TABLE 3. Noncharitable Gifts in Trust and Not in Trust, All Decedents, 1957 and 1959

(Dollar amounts in thousands)

Estate size	Number of decedents with non-charitable gifts	Total amount of non-charitable gifts	Noncharitable gifts in trust		Noncharitable gifts not in trust		Gifts in trust as a percentage of all gifts	
			Number of decedents	Amount	Number of decedents	Amount	Number	Amount
1957								
Small	40	\$1,147	1	\$25	40	\$1,123	2.5	2.2
Medium	263	15,311	13	687	262	14,623	4.9	4.5
Large	583	154,652	132	45,044	577	109,608	22.6	29.1
1959								
Small	48	1,509	2	67	48	1,442	4.2	4.2
Medium	299	21,579	33	2,261	298	19,319	11.0	10.5
Large	636	180,933	169	50,509	633	130,424	26.6	27.9

Comparable data for the millionaire decedents are set out in

Table 4:

TABLE 4. Noncharitable Gifts in Trust and Not in Trust, Millionaire Decedents, 1957 and 1959 Returns Combined

(Dollar amounts in thousands)

Size of gross transfers	Number of decedents with non-chari-gifts	Total amount of non-charitable gifts	Noncharitable gifts in trust		Noncharitable gifts not in trust		Gifts in trust as a percentage of total	
			Number of de-cedents	Amount	Number of de-cedents	Amount	Number	Amount
Under \$900	28	\$2,364	1	\$56	28	\$2,308	3.6	2.4
900- 1,000	34	1,075	4	182	34	893	11.8	16.9
1,000- 1,250	228	15,685	33	2,013	228	13,672	14.5	12.8
1,250- 1,500	196	22,560	38	3,417	196	19,143	19.4	15.1
1,500- 1,750	130	20,483	27	3,653	130	16,830	20.8	17.8
1,750- 2,000	117	20,951	35	4,212	116	16,739	29.9	20.1
2,000- 3,000	195	46,246	56	10,440	192	35,806	28.7	22.6
3,000- 5,000	153	63,386	44	14,294	152	49,032	28.8	22.6
5,000-10,000	90	59,775	40	27,687	88	32,088	44.4	46.3
10,00 or more	48	83,060	23	29,599	46	53,461	47.9	35.6
Total	1,219	335,585	301	95,553	1,210	240,032	24.7	28.5

Finally, with respect to those decedents who used trusts for lifetime giving, the data indicate that generation-skipping trusts were used principally by the millionaire decedents, and that the bulk of the generation-skipping trusts created *inter vivos* by the millionaire decedents skipped one generation only. The data are summarized in Table 5:

TABLE 5. Noncharitable Trusts Created During Life, by Type of Trust, All Decedents, 1957 and 1959

(Dollar amounts in thousands)

Estate size	Number of decedents creating trusts during life	Number of trusts	Total value of trusts	Trusts for a term of years		One generation only			
				Number	Amount	Life tenant: spouse		Other than spouse	
						Number	Amount	Number	Amount
1957									
Small	1	1	\$25	--	--	--	--	1	\$25
Medium	13	20	687	--	--	3	\$69	12	476
Large	132	413	45,144	10	\$534	57	10,495	272	25,790
1959									
Small	2	2	67	--	--	1	10	1	57
Medium	33	62	2,261	2	22	20	707	32	723
Large	162	598	50,509	49	2,545	56	2,887	392	32,241
		One generation plus a term of years		Two generation only		Two generations plus a term of years		Three generations only	
		Number	Amount	Number	Amount	Number	Amount	Number	Amount
1957									
Small	--	--	--	--	--	--	--	--	--
Medium	2	\$110	3	\$32	--	--	--	--	--
Large	18	3,852	36	3,300	20	\$1,073	--	--	--
1959									
Small	--	--	--	--	--	--	--	--	--
Medium	6	740	--	--	1	6	1	\$53	
Large	53	7,817	41	4,526	6	348	1	145	

A breakdown of the types of trusts utilized by the millionaire decedents indicates that about two-thirds of these dispositions involved single generation skips and that single generation-skipping trusts and a percentage of all trust dispositions also increased as estate size increased. Table 6 summarizes this data:

TABLE 6. Noncharitable Trusts Created During Life, Millionaire Decedents, 1957 and 1959 Returns Combined

(Dollar amounts in thousands)

Size of gross transfers	Number of decedents creating trusts during life	Number of trusts	Total value of trusts	Trusts for a term of years		One generation only, life tenant					
				Number of Trusts	Amount	Spouse		Other than spouse			
						Number of Trusts	Amount of Trusts	Number of Trusts	Amount of Trusts		
Under \$900	1	1	\$56	--	--	1	\$56	--	--		
900- 1,000	4	5	182	--	--	--	--	2	\$32		
1,000- 1,250	33	65	2,013	8	\$137	6	413	33	880		
1,250- 1,500	38	75	3,417	6	159	15	715	38	1,212		
1,500- 1,750	27	67	3,653	5	313	8	383	43	2,091		
1,750- 2,000	35	77	4,212	14	792	12	873	47	2,265		
2,000- 3,000	56	140	10,440	13	1,251	30	1,899	76	5,459		
3,000- 5,000	44	145	14,294	6	131	15	1,423	71	7,059		
5,000-10,000	40	159	27,687	4	123	10	2,438	106	16,425		
10,000 or more	23	277	29,599	3	173	16	5,182	248	22,608		
Total	301	1,011	95,553	59	3,079	113	13,382	664	58,031		
				One generation plus a term of years		Two generations plus a term of years		Three generations only			
				Two generations only							
				Number of trusts		Amount		Number of trusts		Amount	
				Number of trusts		Amount		Number of trusts		Amount	
Under \$900	--	--	--	--	--	--	--	--	--	--	--
900- 1,000	--	--	3	\$150	--	--	--	--	--	--	--
1,000- 1,250	8	\$184	4	144	5	\$110	1	\$145	--	--	--
1,250- 1,500	6	566	6	450	4	315	--	--	--	--	--
1,500- 1,750	6	621	3	183	2	62	--	--	--	--	--
1,750- 2,000	3	147	1	135	--	--	--	--	--	--	--
2,000- 3,000	6	552	10	625	5	654	--	--	--	--	--
3,000- 5,000	26	3,047	18	2,409	9	225	--	--	--	--	--
5,000-10,000	15	6,050	23	2,596	1	55	--	--	--	--	--
10,000 or more	1	502	9	1,134	--	--	--	--	--	--	--
Total	71	11,669	77	7,826	26	1,421	1	145	--	--	--

The foregoing data show that the absolute amount of lifetime giving as a percentage—of total transfers is relatively small, that the percentage of dispositions in trust is even smaller and the percentage of trust dispositions in generation-skipping form is smaller still. Yet the data also show that to the extent lifetime gifts are made in trust, the trust disposition is utilized principally by the millionaire decedents and a significant number of those trust dispositions are in a form which skip at least one generation.

Among the millionaire decedents who used inter vivos trusts, 83 percent of the trusts were generation-skipping and almost 83 percent of the amounts transferred were transferred to those trusts. Of the generation-skipping trusts created, 79 percent skipped only one generation. For decedents with gross estates in excess of \$2,000,000, 86.5 percent of the trusts and 84.7 percent of the amount of trust transfers were in generation-skipping form. For those possessing gross estates in excess of \$5,000,000 the comparable percentage are 92.5 and 86.2.

Part II. Testamentary Transfers
 Excerpts from Anthoine, Trust Dispositions,
 Appendix B of Shoup, Federal Estate and Gift Taxes
 (Brookings 1967):

Using the special tabulations prepared by the Internal Revenue Service, this appendix summarizes the information on testamentary trusts created by the wills of decedents whose estate tax returns were filed in 1957 and 1959.

Noncharitable Transfers in Trust

Millionaires

In 1957 there were 1,119 millionaires' returns reporting gross transfers at death of \$2.6 billion (Table B-1), and of this number 607 millionaire decedents created 1,119 trusts¹ containing property with a value of \$455 million (Table B-4). In 1959 there were 1,157 decedents and \$2.5 billion of gross transfers at death (Table B-1). In the returns for that year 646 decedents created 1,334 trusts containing property with a value of \$418 million (Table B-4).

In the returns for 1957, the ratio of noncharitable bequests in trust to total noncharitable bequests rises, with some deviations, to a high of 41.1 percent in the \$5 million to \$10 million category. The highest gross transfer classification of \$10,000,000 or more shows a ratio of 33.8 percent. The second highest ratio is in the \$1.75-\$2 million category, in which the ratio is 37.4 percent. There is a greater use of trusts in the gross transfer classifications above \$1,750,000 (noncharitable bequests in trust averaging about 56 percent of all noncharitable bequests) than in the gross transfer classifications from \$900,000 to \$1,750,000, in which the ratio averages about 28 percent (Table B-1).

In the returns for 1959, the highest ratio of noncharitable bequests in trusts as a percentage of all noncharitable bequests is found in the \$3-\$5 million class. For decedents with gross transfers of less than \$900,000, the ratio is 18.4 percent. This ratio again rises gradually, with deviations, as the gross transfer size increases to the high of 37.4 percent in the \$5 million to \$5 million category. The two highest gross transfer categories show 28.3 percent and 28.0 percent, respectively.

With respect to 1957, 54.2 percent of the millionaire decedents transferred property to noncharitable trusts (Table B-2). The value of such trust property amounted to 17.8 percent of the value of gross transfers at death and 32.2 percent of the value of all noncharitable bequests. In the 1959 returns 56.8 percent of the millionaire decedents transferred property to noncharitable trusts. The value of such trust property was 18.3 percent of the value of gross transfers at death, and 31.2 percent of the value of all noncharitable bequests.

¹ By an extraordinary coincidence, the number of millionaires' returns in 1957 was exactly the same as the number of trusts created in those returns (1,119). In some returns, no trusts were created; in others, only one; in still others, two or more trusts. In 1959 the totals were 1,157 decedents and 1,334 trusts.

TABLE B-1. Disposition of Gross Transfers at Death by Selected Ratios, Millionaires, 1957 and 1959

(Dollar amounts in thousands)

Size of gross transfers	Gross transfers at death		Charitable bequests as a percentage of gross transfers ^a	Non-charitable bequests as a percentage of gross transfers ^a	Total bequests as a percentage of gross transfers ^a	Noncharitable in-trust bequests ^b		Charitable in-trust bequests ^b	
	Number of decedents	Amount				As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers
1957									
Under \$900	47	\$ 29,731	3.9	75.6	20.6	40.4	19.0	24.0	25.2
900-1,000	75	71,284	7.3	70.7	22.0	53.3	19.7	25.2	27.9
1,000-1,250	260	283,076	3.9	70.4	23.6	31.9	20.0	26.2	28.4
1,250-1,500	191	247,312	8.0	68.1	23.9	51.8	18.3	24.1	26.9
1,500-1,750	118	178,734	9.6	66.3	24.1	48.3	15.9	20.9	23.9
1,750-2,000	78	158,172	9.8	64.2	26.8	57.7	24.0	32.8	37.4
2,000-3,000	155	356,433	10.6	61.2	28.2	57.4	21.2	29.6	34.7
3,000-5,000	105	370,080	9.8	59.8	31.2	59.0	19.7	28.6	32.9
5,000-10,000	44	372,531	19.6	47.4	33.0	68.8	19.5	29.1	41.1
10,000 or more	26	508,646	29.2	29.8	41.0	65.4	10.0	17.0	33.8
Total	1,119	2,552,449	14.3	55.4	30.3	54.2	17.8	25.6	32.2
1959									
Under \$900	52	\$ 31,944	4.1	76.0	19.9	34.6	14.0	17.5	18.4
900-1,000	62	59,349	6.7	71.8	21.5	31.6	17.4	23.1	24.2
1,000-1,250	263	285,826	3.9	70.6	23.5	31.7	19.1	24.9	27.9
1,250-1,500	190	247,428	6.0	70.6	23.3	34.7	21.2	27.6	30.0
1,500-1,750	118	179,745	9.2	66.6	24.3	61.0	22.1	29.2	33.2
1,750-2,000	103	177,878	7.2	67.6	25.2	64.1	22.4	30.0	33.2
2,000-3,000	162	364,777	14.9	59.3	25.9	59.9	20.8	29.0	35.0
3,000-5,000	110	373,001	13.4	57.1	29.3	64.3	21.3	30.3	37.4
5,000-10,000	51	308,654	13.6	52.3	34.1	59.8	14.8	22.5	28.3
10,000 or more	26	422,789	29.8	38.6	31.5	76.9	10.8	15.8	29.0
Total	1,137	2,451,401	13.8	59.6	27.6	56.8	18.3	25.2	31.2

Source: U. S. Treasury Department.

^a Gross transfers at death.^b Death taxes consist of: net federal estate tax (net of, after tax credits), gift taxes credited against federal estate tax, state death taxes, and foreign death taxes.*All Decedents*

Table B-2 shows the disposition of gross transfers for all decedents by sample strata—small, medium, and large estates, as defined in Appendix A. Table B-6 sets forth the amounts placed in trust by sample strata and the percentage of trust corpora skipping generations.

TABLE B-2. Disposition of Gross Transfers at Death by Selected Ratios, Summary by Sample Strata, 1957 and 1959

Size of gross transfers	Gross transfers at death		Charitable bequests		Non-charitable bequests		Trusts		Noncharitable transfers in trust bequests ¹		Noncharitable transfers in trust bequests as a percentage of gross transfers at death ²	
	Number of decedents	Amount (in thousands of dollars)	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers	As a percentage of gross transfers
1957												
Small	398	45,162	3.4	91.6	5.0	13.6	8.4	8.8	9.1			
Medium	876	387,160	5.0	76.8	18.2	27.0	16.5	20.2	21.5			
Large	1,119	2,555,445	14.3	55.4	30.3	54.2	17.8	25.6	32.2			
1959												
Small	471	54,786	2.5	91.9	5.6	16.1	9.7	10.2	10.5			
Medium	968	439,102	4.4	77.7	17.8	40.3	17.0	20.7	21.9			
Large	1,127	2,451,401	13.8	58.6	27.6	56.8	18.3	25.7	31.2			

Source: U. S. Treasury Department.

¹ Gross transfers at death.² Death taxes are composed of net federal estate tax (that is, after tax credits), gift taxes credited against federal estate tax, state death taxes, and foreign death taxes.

In Table B-2 and the following tables, the numbers of returns and the dollar amounts for "small" and "medium" estates are numbers and amounts in the sample, not the "blown-up" figures used in the special study tables in order to facilitate comparisons with the millionaire returns.⁶

The recapitulation for sample strata shows, as would be expected, that the percentage of property transferred in trust is lowest in the smallest estates. Thus, for the small estates (below \$500,000) in the 1957 returns, the value of property transferred in trust amounted to only 8.4 percent of gross transfers at death and to only 9.1 percent of all noncharitable bequests. For the medium-sized estates (\$500,000-\$1,000,000) the figures are 16.5 percent and 21.5 percent.

In the 1959 returns the value of property transferred in trust by the small estates amounted to 9.7 percent of gross transfers at death and to 10.5 percent of all noncharitable bequests. The equivalent figures for the medium-sized estates are 17.0 percent and 21.9 percent.

Generation-Skipping by Estate Classification

A major purpose of this appendix is to ascertain the amount of generation-skipping involved in the use of trusts. The tables discussed below are intended to indicate the amount of property that is designed to pass through a given number of generations.

The classifications used in the preparation of the tables are not entirely satisfactory. For example, in the Treasury study

one-generation trusts are those with one or more tenants of the same generation. Two-generation trusts are those with tenants belonging to two different generations, and three-generation trusts are those with tenants belonging to three different generations, concurrently or successively. It will be noted that under this classification, a trust in which the sole life tenant is a person of the testator's generation, such as the surviving spouse or a sister, is regarded as a trust in which the corpus skips one generation. On the other hand, a trust in which the testator's grandchildren are the sole life tenants is treated as only a one-generation trust. Furthermore, in the tables showing trust duration, no attempt was made to deter-

nine whether a generation was skipped between the life tenant and the remainderman—for example, income to surviving spouse for life, remainder to grandchildren.

In the trust duration tables, the only identification of trust beneficiaries is that of the surviving spouse either as the sole income beneficiary or as the first of two or more income beneficiaries in two-generation trusts.

The basic tables in this appendix follow the classifications used in compiling the data on trust duration. In addition, the author has made the following changes for purposes of analysis: A trust which terminates on the death of a surviving spouse who was the sole life tenant is not regarded as involving any generation-skipping. A similar principle is followed where the spouse is the first of two successive tenants.

With respect to the category "a term of years," which the study does not attempt to classify in terms of generation-skipping, it is assumed in every instance that a term of years constitutes one generation.

The author's adherence to the classification of trust duration used in compiling the data may result in understating or overstating the amount of generation-skipping. For example, a trust in which the life tenants are the testator's ancestors or are members of the testator's generation, the remainders passing to members of the generation immediately following that of the testator, should be treated as involving no generation skipping, rather than as a one-generation trust. A trust in which the testator's grandchildren are the sole life tenants, with remainders to their children, should be treated as a two-generation trust, rather than as a one-generation trust. An effort was made to compensate partially for this analytical failure by ascertaining, insofar as practicable, the value of property transferred to trusts that should be classified in a category different from that used in the study. Data have been assembled from other tables that show the relationships between the testator and the life tenants and the remaindermen. The results of this inquiry are noted below in the section on "Relationship of Tenants and Remaindermen to Grantor."

Millionaires

Table B-3 shows the relative number of testamentary trusts and the relative amounts of trust corpora in each type of tenancy. In both

years more than 80 percent of the value of trust corpora involved either no generation-skipping or skipping of only one generation.

In general the statistics reveal a good deal of one-generation-skipping in most wealth classes but little beyond that. In both 1957 and 1959, the highest gross transfer classification, \$10 million or more, had the highest percentage of total trust corpora in trusts designed to skip one generation—74 percent and 75 percent, respectively (Table B-4). For the returns filed in 1957, in other gross transfer categories, the percentage of total trust corpora in one-generation trusts reached a low of 44.6 percent in the \$1.75-\$2 million class, and a high of 65.9 percent in the \$5-\$10 million category. For the returns filed in 1959 the lowest percentage of trust corpora to skip one generation was in

TABLE B-3. Percentages of Trusts and of Trust Corpora Skipping Generations by Types of Tenancies, Millionaires, 1957 and 1959

Description of category	Percentage of total number of trusts		Percentage of total value of corpora of trusts	
	1957	1959	1957	1959
1 generation, spouse sole life tenant (no skip)	23.1	15.7	25.9	19.7
Term of years (1 generation skipped)	2.5	4.0	1.0	3.4
1 generation, life tenant other than spouse (1 generation)	56.7	59.3	49.4	49.8
1 generation plus term of years, spouse life tenant (1 generation)	0.7	2.2	1.4	3.3
2 generations, spouse first life tenant (1 generation)	3.7	3.7	7.1	6.0
1 generation plus term of years, life tenant other than spouse (2 generations)	5.3	5.1	8.3	6.6
2 generations, life tenant other than spouse (2 generations)	4.6	6.3	5.5	5.7
2 generations plus term of years (3 generations)	2.5	2.8	2.4	4.1
3 generations, all life tenants (3 generations)	0.7	0.5	0.9	0.8
3 generations plus term of years (4 generations)	0.2	0.3	0.2	0.6

Source: U. S. Treasury Department.

TABLE B-4. Percentages of Value of Trust Corpora Skipping Generations by Size of Gross Transfers at Death, Millionaires, 1957 and 1959

(Dollar amounts in thousands)

Size of gross transfers	Number of decedents creating trusts	Number of trusts	Value of trust corpora	Percentages of value of trust corpora				
				No skip (spouse sole life tenant)	1	2	3	4
					generation	generations	generations	generations plus term of years
1957								
Under \$900	19	24	\$ 5,659	27.1	57.8	8.8	6.3	—
900-1,000	40	67	14,022	47.2	45.5	4.2	3.1	—
1,000-1,250	135	203	56,556	31.2	53.5	8.7	6.6	—
1,250-1,500	99	168	45,274	31.5	57.8	9.8	0.9	—
1,500-1,750	57	92	28,304	32.9	60.7	6.3	—	—
1,750-2,000	45	86	33,134	22.8	44.6	20.0	12.6	—
2,000-3,000	89	172	75,635	22.5	64.2	7.2	6.1	—
3,000-5,000	62	145	72,910	32.2	48.8	19.0	—	—
5,000-10,000	44	86	72,636	13.1	65.9	18.2	1.3	1.6
10,000 or more	17	71	51,117	21.7	74.1	4.1	—	—
Total	607	1,119	455,247	25.9	58.9	11.7	3.2	0.2
1959								
Under \$900	18	25	\$ 4,472	53.7	31.5	13.6	—	—
900-1,000	32	50	10,304	31.2	60.5	3.1	5.2	—
1,000-1,250	136	248	54,549	22.5	69.1	8.1	0.2	—
1,250-1,500	104	187	52,375	26.4	58.1	10.7	3.9	0.9
1,500-1,750	72	131	39,689	29.4	59.6	4.8	4.7	1.2
1,750-2,000	66	119	39,880	20.1	63.2	10.1	4.6	1.9
2,000-3,000	97	223	75,694	16.8	59.1	12.2	10.4	1.4
3,000-5,000	71	189	79,580	15.8	61.8	18.7	3.7	—
5,000-10,000	30	78	45,732	13.1	59.5	24.4	2.9	—
10,000 or more	20	84	45,738	11.7	75.1	5.8	7.5	—
Total	646	1,334	448,013	19.7	62.5	12.2	4.9	0.6

Source: U. S. Treasury Department.

Estate and Gift Tax Project—Generation-Skipping Transfers

TABLE B-5. Percentages of Trusts and of Trust Corpora Skipping Generations by Types of Tenancies, All Decedents, 1957 and 1959, and Sample Strata 1957 and 1959 (Corpora Only)

Description of category	Percentage of total value of trust corpora by sample strata					
	Small		Medium		Large	
	1957	1959	1957	1959	1957	1959
1 generation, spouse sole life tenant (no skip)	58.9	51.0	37.4	38.4	25.9	14.7
Term of years (1 generation skipped)	—	2.7	1.9	1.2	1.0	3.4
1 generation, life tenant other than spouse (1 generation)	25.5	33.5	42.5	39.6	49.4	49.8
1 generation plus term of years, spouse life tenant (1 generation)	—	4.0	2.9	3.8	1.4	3.3
2 generations, spouse first life tenant (1 generation)	5.6	3.8	6.1	6.6	7.1	6.0
1 generation plus term of years, life tenant other than spouse (2 generations)	4.5	0.7	2.3	5.2	6.3	6.6
2 generations, life tenant other than spouse (2 generations)	5.1	2.9	4.5	1.5	5.5	5.7
2 generations plus term of years (3 generations)	—	1.3	2.0	3.3	2.4	4.1
3 generations, all life tenants (3 generations)	—	—	0.5	0.5	0.9	0.8
3 generations plus term of years (4 generations)	—	—	—	—	0.2	0.6

Source: U. S. Treasury Department.

the under-\$900,000 category—31.5 percent—and the second highest percentage was in the \$1-\$1.25 million category—69.1 percent.

There does not appear to be a marked propensity to "tie up" property for long periods in trust as the size of the gross transfer increases. In the 1957 returns, in the highest size classification of \$10 million or more, there was no trust to last beyond two generations, and only 4.1 percent of the approximately \$51 million placed in trust was to be held beyond one generation. In the 1959 returns, in the \$10 million or more category, 7.5 percent of the approximately \$46 million placed in trust was to last for three generations and 5.8 percent for two generations.

All Decedents

Small- and medium-sized estates show a good deal of one-generation-skipping but, as might be expected, little beyond that (Tables B-5 and B-6). In the returns filed in 1957, the small estates transferred 31.5 percent of trust corpora in trust to skip one generation, 9.6 percent in trusts to skip two generations, and nothing beyond that. The equivalent figures for 1959 are 44.1 percent and 3.6 percent, and in that year 1.3 percent of trust corpora was to skip three generations.

In the 1957 returns, the medium-sized estates transferred 53.3 percent of trust corpora in trust to skip one generation, 6.8 percent to

TABLE B-6. Percentages of Trust Corpora Skipping Generations by Size of Gross Transfers at Death, All Decedents, Summary by Sample Strata, 1957 and 1959
(Dollar amounts in thousands)

Size of gross transfers	Number of decedents	Number of trusts	Value of corpora	No skip (gross sale life interest)	Percentage skipping			
					1 gen. erosion	2 gen. erasipes	3 gen. erasipes	4 gen. erasipes
1957								
Small	34	65	3,778	58.9	31.3	9.6	—	—
Medium	324	448	64,007	37.4	59.3	6.8	2.5	—
Large	607	1,119	455,247	25.9	58.9	17.7	3.2	0.2
1959								
Small	76	89	5,289	51.1	44.1	3.6	1.5	—
Medium	390	514	74,747	38.4	51.2	6.7	3.7	—
Large	646	1,334	448,013	19.7	69.3	12.3	4.9	0.6

Source: U. S. Treasury Department.

skip two generations, and 2.5 percent to skip three generations. The equivalent figures for 1959 are 51.2 percent, 6.7 percent, and 3.7 percent.

Thus, in the small estates, for 1957 and 1959, respectively, the percentages of trust corpora designed to skip more than one generation are 9.6 percent and 4.9 percent. The equivalent figures for the medium-sized estates are 9.3 percent and 10.4 percent. These may be compared with the figures for the large estates, which for the two years are 15.1 percent and 17.7 percent.

Summary of Trust Corpora Passing Through Generations

Some of the data in the foregoing tables have been recast in Table B-7 in order to summarize for the millionaires' estates the actual dollar amounts of property passing through the given number of generations, and the ratio of such amounts of property to total trust corpora and to total gross transfers at death.

In the 1957 returns, out of total gross transfers at death by millionaires of \$2.6 billion, \$268 million (10.5 percent) was transferred to trusts that would skip one generation, and \$69 million (2.7 percent) to trusts to skip more than one generation.

In the 1959 returns, out of total gross transfers at death by millionaires of \$2.5 billion, \$280 million (11.4 percent) was transferred to

TABLE B-7. Summary of Percentages and Dollar Amounts of Trust Corpora Passing Through Generations, Millionaires Only, 1957 and 1959
(Dollar amounts in thousands)

Row	No skip (gross sale life interest)		1 generation		2 generations		3 generations		4 generations	
	1957	1959	1957	1959	1957	1959	1957	1959	1957	1959
Percentage of value of trust corpora	25.9	19.7	58.9	62.3	11.7	12.2	3.2	4.9	0.2	0.6
Dollar amounts	118,049	88,136	267,930	280,158	55,475	54,871	14,716	22,023	1,078	2,825
Percentage of total gross transfers at death	4.6	2.6	10.5	11.4	2.1	2.2	0.6	0.9	—	0.1

Source: U. S. Treasury Department.

* Less than 0.05 percent.

trusts that would skip one generation, and \$80 million (3.1 percent) to trusts to skip more than one generation. *

Supplementary Data on Family Relationships

Corrected Estimates of Generation-Skipping

Tables B-8 and B-9 show the family relationships in the most significant categories for millionaire decedents. They indicate that the foregoing data overstate the amount of one-generation skipping and understate the amount of two- and three-generation skipping.

For the year 1957 property valued at \$22.7 million was transferred by millionaires to trusts in which the only life tenants were brothers or sisters. And \$1.5 million was transferred to trusts in which only the parents of the testator were the life tenants. If it is assumed that the remaindermen of those trusts were the children or nephews or nieces of the testator, these trusts should be regarded as involving no generation-skipping rather than one-generation skipping, as they have been reported above. Trusts in which the grandchildren were the sole life tenants held a corpus of \$14.3 million. Accordingly the amount of property skipping two generations has been understated by this amount, and the amount skipping one generation has been correspondingly overstated. The amount of \$4.7 million was placed in trusts in which the grandchildren and the great grandchildren of the testator were the sole life tenants. The amount of three-generation skipping has therefore been understated by this sum, and the amount of two-generation skipping has been correspondingly overstated. The other categories are difficult to classify accurately in terms of generation-skipping.

For 1959 the figures for the millionaires are similar to those above, except that the amount of property passing into trusts in which the grandchildren were the sole life tenants was higher by about 50 percent, and the amount passing into trusts in which the grandchildren and great grandchildren were the life tenants decreased sharply from the 1957 figure.

From an examination of the foregoing tables, it appears that the amount of one-generation skipping has been overstated and the amount of two- and three-generation skipping understated. The amount of two-generation skipping reported for 1957 is \$53.5 million. To this figure should be added at least \$14.3 million of trust property to which the grandchildren were the sole life tenants. Similarly, with respect to 1959, to the figure of \$54.8 million of two generation skipping there should be added \$21.1 million of trust property to which the grand-

children were the sole life tenants. As for three-generation skipping, the 1957 figure of \$14.7 million does not include the \$4.7 million of trust property to which the grandchildren and great grandchildren were the sole life tenants. (There were no trusts in 1957 in which great grandchildren alone were life tenants.) The 1959 figure of \$22.0 million does not include approximately \$0.7 million in trust corpus of property to which grandchildren and great grandchildren were the sole life tenants and also does not include \$0.2 million in trusts where great grandchildren alone were the sole life tenants.

TABLE B-8. *Noncharitable Trusts Created at Death by Relationship of Life Tenants^a to Grantor, by Size of Gross Transfers, by Principal Categories, Millionaires, 1957 and 1959*

Item	Total for all tenants	Spouse only	Children only	Brothers or sisters only	Grand-children only	Other relatives only	Near-relatives only	Spouse and children	Children and grand-children
1957									
Number of trusts	1,119	226	357	78	45	91	92	44	33
Percentage in gross transfer class ^b									
Under 500	0.4	1.8					1.1		
500-1,000	8.7	10.2	7.8	7.7		8.8	4.3	20.5	9.1
1,000-2,000	49.1	56.6	52.1	58.4	40.0	39.6	43.5	58.8	33.3
2,000-3,000	15.4	7.1	19.9	12.8	17.8	13.2	23.9	11.4	15.2
3,000-5,000	13.0	8.8	11.2	7.7	8.9	14.3	10.9	6.8	12.1
5,000 and over	14.0	15.5	9.0	15.4	33.3	24.2	16.3	4.5	30.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Value of trusts ^c	455.2	107.3	153.0	22.7	14.3	30.0	14.1	24.9	15.0
Percentage in gross transfer class ^b									
Under 500	0.2	0.6					2.8		
500-1,000	4.1	6.6	3.1	3.7		3.1	4.1	6.8	3.1
1,000-2,000	35.9	43.9	28.8	48.7	29.6	26.8	38.6	54.5	33.8
2,000-3,000	16.6	11.8	10.4	10.7	11.5	9.9	19.8	16.4	17.1
3,000-5,000	16.0	17.5	18.0	16.9	1.6	18.5	6.2	17.8	8.9
5,000 and over	27.2	19.6	29.7	20.1	57.2	41.7	28.6	4.4	37.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1959									
Number of trusts	1,334	208	411	101	79	135	167	56	36
Percentage in gross transfer class ^b									
Under 500	0.3	1.0						1.8	
500-1,000	5.4	10.1	5.6	5.0	6.3	3.0	3.0	5.4	
1,000-2,000	51.3	52.4	59.9	55.4	30.4	40.7	42.5	64.3	33.3
2,000-3,000	16.7	12.5	10.9	22.8	5.1	30.4	23.4	14.3	22.2
3,000-5,000	14.2	18.3	13.1	14.9	26.6	11.9	11.4	10.7	17.1
5,000 and over	12.1	5.8	10.5	2.0	31.6	14.1	19.8	3.6	33.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Value of trusts ^c	448.0	89.1	157.4	22.5	21.1	27.5	15.1	30.5	25.8
Percentage in gross transfer class ^b									
Under 500	0.1	10.3						0.6	
500-1,000	3.2	6.0	2.7	1.5	2.2	2.8	2.0	3.1	
1,000-2,000	41.6	50.6	42.7	55.2	21.1	23.7	40.2	50.2	22.7
2,000-3,000	16.9	15.9	12.8	16.6	11.0	36.5	20.3	17.1	13.3
3,000-5,000	17.8	12.7	18.3	20.8	17.3	25.9	16.9	18.5	25.0
5,000 and over	20.4	14.6	23.4	5.9	48.4	11.1	20.8	10.5	39.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: U. S. Treasury Department.

^a Includes tenants for a term of years. ^b Transfer classes in thousands of dollars. ^c Value of trusts in millions of dollars.

TABLE B-9. Noncharitable Trusts Created at Death, by Relationship of the Remaindermen to Grantor and by Size of Gross Transfers, by Principal Categories, Millionaires, 1957 and 1959

Item	Total for all remaindermen	Children only	Grand-children only	Other relatives only	Charity only	Subject to power of appointment in life tenants
1957						
Number of trusts	1,119	160	394	155	120	55
Percentage in gross transfer class ^a						
Under 500	0.4	1.9		0.6		
500-1,000	8.1	9.4	7.4	10.3	4.2	18.2
1,000-2,000	49.1	58.1	49.0	49.7	37.5	52.7
2,000-3,000	15.4	15.6	18.5	13.5	18.3	7.3
3,000-5,000	13.0	7.5	15.2	12.3	6.7	12.7
5,000 and over	14.0	7.5	9.9	13.5	33.3	9.1
Total	100.0	100.0	100.0	100.0	100.0	100.0
Value of trusts ^b	455.2	66.3	181.8	72.1	22.9	19.5
Percentage in gross transfer class ^a						
Under 500	0.2	0.7		0.3		
500-1,000	4.1	5.5	2.8	5.1	4.9	8.4
1,000-2,000	35.9	48.9	29.5	32.3	38.8	37.9
2,000-3,000	16.6	18.5	20.2	18.0	18.3	5.3
3,000-5,000	16.0	11.3	17.7	10.5	11.5	15.5
5,000 and over	27.2	15.1	29.7	33.9	26.4	32.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
1959						
Number of trusts	1,334	184	399	190	174	101
Percentage in gross transfer class ^a						
Under 500	0.2	1.1				
500-1,000	5.4	12.0	5.5	3.7	3.4	3.0
1,000-2,000	51.3	62.5	55.9	47.4	40.2	52.5
2,000-3,000	16.7	12.0	13.8	28.4	21.8	8.9
3,000-5,000	14.2	7.6	11.5	11.6	19.5	20.8
5,000 and over	12.1	4.9	13.3	8.9	14.9	14.9
Total	100.0	100.0	100.0	100.0	100.0	100.0
Value of trusts ^b	448.0	63.3	167.7	53.8	24.1	30.0
Percentage in gross transfer class ^a						
Under 500	0.0	0.4				
500-1,000	3.2	6.3	2.3	2.3	2.7	1.8
1,000-2,000	41.6	60.5	41.2	41.6	26.3	35.3
2,000-3,000	16.9	11.7	12.4	27.4	22.9	14.2
3,000-5,000	17.8	10.5	17.4	21.4	11.7	24.3
5,000 and over	20.4	10.6	26.8	7.3	36.4	24.3
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: U. S. Treasury Department.

^a Transfer classes in thousands of dollars. ^b Value of trusts in millions of dollars.

Table B-9 describes the principal categories of remaindermen in terms of their relationship to the testator, again for millionaire decedents only. This table reveals that there is somewhat more generation-skipping than is indicated in the above analysis because the remaindermen may be more than one generation removed from the life tenants. This aspect is revealed by the basic Treasury tables, which are not reproduced here. They show, for example, that of all the trusts created by the millionaire decedents whose tax returns were filed in 1957, the surviving spouse was the sole life tenant in trusts holding property with a value of \$102 million. The remaindermen by relationship to the testator, and the value of the trusts involved, were as follows:

Remaindermen	Amounts (In thousands of dollars)
Children only	52,427
Parents only	437
Brothers or sisters only	1,165
Grandchildren only	3,729
Other relatives only	6,696
Nonrelatives only	3,139
Charity only	6,495
Subject to power of appointment	5,910
Children and grandchildren	7,184
Children and other relatives	649
Children and charity	609
Brothers or sisters and others	1,740
Grandchildren and nonrelatives	2,368
Other relatives and nonrelatives	5,521
Other undescribed categories	4,236
Total	102,505

With respect to the same year, 1957, for the millionaires, the children were the sole life tenants in trust having a total corpus of \$153 million. The remaindermen by relationship to the testator, and the value of the trusts involved, were as follows:

Remaindermen	Amounts (In thousands of dollars)
Children only	949
Brothers or sisters only	241
Grandchildren only	121,582
Great grandchildren only	864
Other relatives only	1,350
Nonrelatives only	1,867
Charity only	1,418
Subject to power of appointment	10,678
Spouse and nonrelatives	140
Children and nonrelatives	1,236
Grandchildren and great grandchildren	3,283
Grandchildren and other relatives	2,877
Grandchildren and nonrelatives	4,489
Grandchildren and charity	513
Other relatives and nonrelatives	485
Other undescribed categories	842
Total	153,014

The foregoing indicates some, but probably not a significant amount of, additional generation-skipping as the result of skipping a generation between the life tenants and the remaindermen.

Considered together, the additional generation-skipping revealed by Tables B-8 and B-9 and by the Treasury study is substantial but is not of such dimension as to affect significantly the revenue estimates described earlier. The revenue effects of taxing the termination of life estates would not be altered at all. Indeed, some other taxing device would have to be constructed to attack the skipping of generations that occurs through (1) transfers to trusts in which the first life beneficiary is more than one generation removed from the testator and (2) transfers of trust property, on termination, to remaindermen who are more than one generation removed from the last life tenant. Such a tax, to be uniform in application, should also be imposed upon outright bequests that skip more than one generation. To be sure, the

trust, with its almost unlimited flexibility, facilitates the kind of additional generation-skipping described above.

Comments on Generation-Skipping

One may wonder why the wealthier citizens of the country do not take greater advantage of the tax savings to be derived from long-term trusts. The instability characteristic of our time, and perhaps the lack of family solidarity, may account for the failure of testators to look as far ahead as the tax advantages might dictate. The fact that estates today are composed largely of securities as distinguished from landed wealth may also be significant.

The data given above on 1957 and 1959 estate tax returns suggests that the normal family trust today involves a substantial amount of one generation skipping but little beyond that. But the pattern shown in the 1957 and 1959 returns may not reflect the current practice. The dates of execution of the wills of the decedents whose returns were filed in 1957 and 1959 are not furnished. Presumably most of the millionaires' wills had been revised after the marital deduction was introduced in 1948.

Family trust dispositions may vary from one part of the country to another, and lawyers within the same community differ as to the amount of generation skipping that is presently being generated through inter vivos and testamentary trusts. Discussions that the author has held with lawyers in New York lead him to believe that there is currently a considerable amount of one-generation skipping, but relatively little beyond that. Indeed, several lawyers have noted recent instances in which clients left the bulk of their property outright to their children (who had already attained majority and were responsible persons). They did this because: (1) it is their children whom they wish primarily to benefit, not their grandchildren or great grandchildren; (2) each generation should bear the direct responsibility for the management of the family property—and with the responsibility of decision-making goes authority, including parental authority; and (3) the possibility that the property passing to subsequent generations upon the death of the children may bear a higher estate tax burden than if it had been placed in trust is largely irrelevant and may be offset by the use that the children will make of the entire property over a substantial period. However, some lawyers, both in New York and elsewhere, have indicated that in recent years a number of wealthy individuals have concluded that most of the advantages of complete ownership can be given to the beneficiary of a

trust, and that the pattern may be changing in the direction of greater use of trusts to skip generations. It seems certain that the limited (nontaxable) power of appointment in the life tenant is in greater use now than the 1957 and 1959 data would indicate.

Whether a serious effort should be made to modify the present treatment, for example, by imposing a transfer tax on the termination of a life estate, depends upon one's view of the estate tax generally, and of the social utility of trusts. It also depends upon whether it is felt that the present amount of generation-skipping through trusts raises a substantial equity problem. The question is fundamentally one of equity since the revenue gained by the change would be relatively small.

The American Law Institute in 1963 undertook a comprehensive study of estate and gift taxation. The topics include generation-skipping through various forms of bequest and the legal problems that would be encountered in any change in the present law. This study should provide a basis for judgment as to the desirability of changing the present system.

Relationship of Tenants and Remaindermen to Grantor

Table B-8 sets forth data with respect to noncharitable trusts created at death by the millionaires in terms of the relationship, in principal categories only, of life tenants or tenants for a term of years to the grantor, by size of gross transfers at death. Table B-9 contains data with respect to noncharitable trusts created at death by millionaires in terms of the relationship, in principal categories only, of remaindermen to the grantor, by the size of gross transfers; the relationship categories include charity and trusts subject to power of appointment. There are two matters in connection with these tables or their underlying data that deserve comment.

First, an analysis was made of the amount of trust corpus subject to a power of appointment in the life tenant, but no attempt was made to classify the type of power as a general or nongeneral power.

Hence, it is not possible to determine from any of the data available how much trust corpus was subject to a nongeneral power of appointment that would not have required the inclusion of the trust corpus in the holder's estate. However, it is clear that the figures given set an outer limit for the amount of trust corpus subject to such nongeneral powers.

The amount of trust corpus subject to a power of appointment in the life tenant for the millionaires in 1957 was \$19.5 million out of total trust corpus of \$455.2 million, or 4 percent. For 1959 the equivalent figures are \$30.0 million out of \$448.0 million, or 7 percent (see Table B-9).

Second, there is an almost complete absence of a mandatory direction to the trustee to accumulate income. The only testamentary transfers under which trust income was directed to be accumulated in 1957 or 1959 consist of two trusts set up by 1959 millionaire decedents with a total combined corpus of \$100,000 in which there was a mandatory direction to accumulate income for a term of years for the benefit of grandchildren. An examination of the data that was compiled for lifetime transfers reveals no lifetime transfer in which a mandatory direction to accumulate was present. Apparently in cases in which the grantor expected the income to be accumulated, the trustee was given the discretion either to accumulate or distribute income.

Appendix CHistorical Recognition and Characterization of the Skipping "Problem"

This Appendix is an historical review of the recognition of the skipping issue and briefly describes the solutions proposed to deal with the problem as identified.

A. Transfers In Which Intervening Generations Possessed An Economic Interest In The Transferred Property. The estate and gift tax does not treat the expiration of an income interest in property as a taxable transfer. The tax avoidance possibilities inherent in trust dispositions which could string successive life estates through a period limited only by the rule against perpetuities were recognized in the United Kingdom as early as 1894; the British death duty treated the expiration of a life interest in settled property as a transfer of the underlying property by the life tenant.

The life estate-remainder disposition was not characterized as an avoidance problem in the United States until much later. William Schultz, writing in 1926, observed that one-quarter of inherited property was devised in life estate-remainder dispositions.¹ However, he apparently did not view these dispositions

¹W. Schultz, The Taxation of Inheritance 223-224 (Houghton Mifflin 1926).

as serious tax avoidance devices.² A Joint Committee on Internal Revenue Taxation Staff Report issued in 1933³ listed a number of transfer tax avoidance devices such as lifetime giving, failure to exercise a general power of appointment and testamentary charitable giving; it did not list the life estate-remainder disposition. In 1935, President Roosevelt sent a message to Congress requesting that the federal death tax structure be strengthened, in part by the enactment of a supplementary inheritance tax. That message did not address the tax treatment of the termination of a beneficial interest in property.⁴ Moreover, a 1940 estate planning text, while warning of the estate tax consequences of retaining an interest in previously transferred property, did not mention the tax minimization opportunities afforded by the life

²The life estate-remainder technique was not listed when Schultz discussed avoidance techniques in Ch. 19 of his book.

³Staff of Jt. Comm. on Internal Revenue Taxation, Federal and State Death Taxes 115-116 (1933) cited in Jantscher, Trusts and Estates Taxation 9 n.22 (Brookings 1966) [hereinafter cited as "Jantscher"].

⁴Jantscher, supra note 3, at 9 n.23. In a statement presented to the House Ways and Means Committee in 1973, James B. Lewis stated that the Treasury had, in fact, developed a proposal for taxing generation-skipping arrangements in 1935 but that the President had misinterpreted the proposal and requested the inheritance tax instead. Staff of Comm. on Ways and Means, Background Materials on Federal Estate and Gift Taxation, 94th Cong., 2d Sess. 85 (Comm. Print 1976).

estate-remainder combination.⁵

By 1941 a different approach was described. Willard C. Mills, a member of the Treasury Division of Tax Research, suggested in that year that the termination of a right to enjoy the economic benefits of transferred property be subject to tax, either by treating the termination as a transfer of the underlying property (as in the British system) or through the device of an "acquisitions" tax.⁶ Mills was principally concerned with the revenue loss associated with such transfers. In proposing taxation of the termination of a life estate he noted that exemption of this form of disposition from taxation "is logical under the statute which reaches only interests in property over which a decedent had a power of disposition at the time of his death." However, he concluded that the exemption resulted in abuse and that therefore, "there [was] a need for quickly casting off this tyranny of narrow logic."⁷

Randolph Paul also described the life estate-remainder disposition as an avoidance device.⁸

⁵M. Garwood, Estate Planning to Minimize Taxes (Prentice Hall 1940) cited in Jantscher, supra note 3, at 9 n.24.

⁶Mills, "Transfer From Life Tenant to Remainderman," 19 Taxes 195 (1941).

⁷Id. at 196.

⁸Paul, Taxation for Prosperity 311, 315 (1947).

Writing in 1947, he noted four ways the issue could be approached. First, an additional tax could be imposed upon the transferor in the event of a transfer in trust. Second, the property could be subjected to tax at the time beneficial ownership shifts. Third, a supplementary tax (not based on the amount of transfers made by the transferor) could be imposed on property transferred in trust. Fourth, an accessions tax could be enacted.

A 1947 Study on Federal Estate and Gift Taxes prepared jointly by an independent advisory committee and the Treasury Department made proposals to unify the separate estate and gift tax structure and to integrate the transfer tax with the income tax. The study recognized the considerable tax advantages to be gained by life estate-remainder settlements of property for more than one generation. However, in view of the problems perceived in taxing the settled property at the death of the life tenant, it concluded that recommendations to eliminate the problem should be deferred until a thorough study of the subject had been made.⁹

The issue received its first extensive examination by William Vickrey in a series of publications in 1944 and 1947.¹⁰ To cure the problem as he perceived it and

⁹Treasury Department Advisory Comm., Federal Estate and Gift Taxes 62 (1947).

¹⁰Vickrey, Agenda for Progressive Taxation Ch. 8 and Appendix IV (Roland Press 1947); Vickrey, "An Inte-

to assure the appropriate calculation of the tax base, he proposed a successions tax based upon "bequeathing power," a concept which reflected the relative ages of the transferor and transferee. While regarded by some as "the only fairly loophole-proof formula that has yet been devised to assure transfer taxation once a generation and no more," Vickrey's plan never received serious critical study.¹¹

In the late 1940s the Treasury began serious study of the problem. The Internal Revenue Service examined a sample of estate tax returns filed in 1945 to determine, among other things, the extent of generation-skipping occurring through testamentary life estate-remainder dispositions. Of the estates above \$500,000 surveyed, 45 percent of the amount transferred was transferred in trust.¹² Of the amount transferred in trust, 37 percent was transferred to trusts in which the next tax would be due upon the death of grandchildren, thus skipping one generation. Approximately 15 percent was transferred to trusts which skipped two generations. In 26 percent of the dispositions, the tax would fall due upon the death of a non-lineal relative and thus,

grated Successions Tax," 22 *Taxes* 368 (1944).

¹¹C. Shoup, Federal Estate and Gift Taxes 102 (Brookings 1967).

¹²Surrey, "An Introduction to Revision of the Federal Estate and Gift Taxes," 38 *Calif. L. Rev.* 1, 18-19 (1950).

although some generation-skipping might have occurred, the amount could not be quantified. The study also revealed that the greater the wealth of the decedent, the greater the proportion of that wealth placed in trusts which skipped two generations.

President Truman, in his 1950 message on tax revision, noted that large fortunes could be transmitted from one generation to the next free of transfer tax through the use of life estates and urged that "the laws concerning the taxation of transfers . . . by outright disposition and through life estates . . . be coordinated to provide uniform treatment and a base for more effective taxation."¹³ Secretary Snyder reiterated this point in testimony before the Ways and Means Committee.¹⁴ However, the Treasury did not supply any details as to how to accomplish the proposed coordination and the Committee did not pursue the matter further.

Stanley Surrey undertook in 1950 to supply a framework for change. Stating that there "would seem to be little quarrel with Treasury's assertion that a transfer tax should be imposed each time one generation hands down its wealth to another," Professor Surrey

¹³Message of the President on Revision of the Tax Laws, H.R. Doc. No 451, 81st Cong., 2d Sess. 6-7 (1950).

¹⁴Hearings Before House Ways and Means Committee on Revenue Revision of 1950. 81st Cong., 2d Sess. 79 1950.

suggested two alternatives.¹⁵ First, the tax could be based on the transfer tax profile of the life beneficiary and imposed upon the expiration of his interest in the property. Second, the tax could be imposed directly on the remainderman.

The first alternative took as its model the existing British system. However, as Professor Surrey noted, accumulation trusts escape taxation under this regime and a method to deal with that aspect would have to be created.

The second alternative was essentially a special accessions tax. The tax would be an additional excise upon the receipt of property, presumably at a progressive rate based on cumulative accessions. Again, while the straightforward life estate-remainder disposition is easily dealt with in this regime, problems would arise in applying the principle to successive life estates and discretionary trusts.

Professor Surrey pointed out that there is no particular reason to create a special accessions tax applicable only to trust remainder interests. If a form of accessions tax is a reasonable solution to this problem, why not replace the existing transfer tax with a universally applicable accessions tax? Professor Surrey concluded for reasons not directly relevant to

¹⁵Surrey, *supra* note 12.

the issue at hand that a comprehensive, cumulative accessions tax was not feasible.¹⁶ He further concluded that an adaptation of the British approach was a better choice than creating a supplementary accessions tax. However, he was careful to point out that a statute designed to deal equitably with all possible dispositive schemes under either alternative would necessarily be complex.

In 1949, the American Law Institute commenced a project on revision of the 1939 Code. The principal focus of that project was the income tax, although a transfer tax project was also created. The transfer tax project was never completed. However, at the stage of development it had reached prior to abandonment, the consultant's group had not recommended any changes in existing law respecting generation-skipping transfers. Congress, in enacting the 1954 Code, did not focus on generation-skipping transfers and this aspect of current law was retained.

To summarize briefly, prior to 1960 the skipping issue had been identified as a "problem" in the transfer tax structure. The "problem" had been defined by most commentators as the failure to deal

¹⁶Professor Surrey stated that an accessions tax would require the abandonment of years of experience under the estate and gift tax; lower exemptions and higher rates to achieve the same revenue levels; and additional complexity to deal with dispositions in trust.

adequately with trust dispositions in which an intervening beneficiary had an economic interest in the transferred property. Broad solutions had been proposed, but no technical studies had been published.

B. Property Subject to a Power of Appointment.

During the same period, attention was also focussed on a different type of skipping transfer. The issue was the transfer tax consequences of the possession of a power of appointment over transferred property.

Estate planners knew that granting a power of appointment by deed or will to a third party was the substantive equivalent of giving the power holder outright ownership of the property subject to the power if the power holder could appoint the property to himself. Yet prior to 1942 if the power was not exercised by the holder, its lapse or termination was not treated as a transfer of the property subject to the power. Thus A could create a trust for the benefit of C granting to B the power to withdraw income or corpus at any time. If B never exercised the power, no transfer occurred at B's death despite the fact that B had possessed total control over the corpus and income during his life. Thus, a skipping transfer had occurred. A's wealth moved to C unreduced by any transfer tax on the holder of the intervening interest.

The tax avoidance possibilities inherent in the use of powers of appointment were fully ventilated by Professor Leach in a 1938 article in the American Bar

Association Journal.¹⁷ Dean Griswold responded in 1939 by proposing the taxation of property subject to a general power of appointment whether or not the power was exercised.¹⁸ He also proposed that property subject to most special powers (i.e., powers that could not be exercised for the benefit of the holder) be included in the tax base of the holder to be taxed upon the exercise, lapse, release or termination of the power. The proposal to treat property subject to a general power as includible in the tax base of the power-holder whether or not the power was exercised was grounded in the notion that the property was in fact subject to the power-holder's control. The failure to exercise the power was simply an exercise of the power-holder's choice in favor of the takers in default. There should be no difference in treatment of the right to control the property depending upon whether the right was affirmatively or negatively asserted. As Dean Griswold stated,

Death taxes are levied at critical points in the continuing process of the transmission of property from the dead to the living--'on the occasion of change in legal relationships to property brought about by death.' This transmission and change are as effectively present when a power terminates as when it is exercised The discrimination, which in practice operates in favor of large

¹⁷Leach, "Powers of Appointment," 24 A.B.A. J. 807 (1938).

¹⁸Griswold, "Powers of Appointment and the Federal Estate Tax," 52 Harv. L. Rev. 929 (1939).

estates, should be eliminated by imposing a tax on those who have control over property, whether that control is called ownership or power.¹⁹

A similar argument was made with respect to special powers of appointment. Dean Griswold noted "the facility for evasion and avoidance" afforded by the special power and noted further that a power could very easily be made special "without materially altering the donee's freedom of choice." Returning to the theme of equating the power to control disposition with ownership, Dean Griswold concluded that even the holder of a special power should be subject to transfer tax because "his act or failure to act is a substantial factor in the process of transmission from the dead to the living."²⁰

Dean Griswold rejected the assertion that special powers should be tax exempt because they serve the socially useful purpose of introducing flexibility into family dispositions. That very flexibility determined the issue. "Flexibility means projection of control, and termination of control is the chief basis for the imposition of an estate tax So far as the estate tax finds its justification as a periodic imposition on the control and transmission of wealth it would seem in many cases to be justified here."²¹

¹⁹ *Id.* at 954-955.

²⁰ *Id.* at 958.

²¹ *Id.*

Dean Griswold was willing to exempt from tax special powers exercisable only among the children of the donor or donee where upon default of exercise of the power the property was to be distributed among those classes of beneficiaries. Starting from the premise that the estate tax is a periodic capital levy, he asserted that the tax should not be prolonged "unduly" when compared to the tax burden borne by property not subject to a special power. The question then became what was "undue prolongation." To answer this question, he turned to the tax treatment of life estate-remainder dispositions. Noting that the expiration of a life estate is not a taxable event despite the fact that the device allows the tax-free transmission of property from one generation to the next, he concluded that the tax would not be "postponed 'unduly' if it is not applied where there is a life estate followed by a power to appoint to a narrowly defined class, such as would normally take the remainder."²² Thus he suggested that to protect the flexibility of the power of appointment while restricting tax avoidance opportunities, powers which would not postpone the tax beyond that permitted by the "ordinary" life tenant-remainder situation could be tax exempt.²³

²²Id. at 960.

²³Dean Griswold's article sparked a spirited exchange with Professor Leach. See 52 Harv. L. Rev. 961-

Dean Griswold's attempt to define the scope of exempt special powers by reference to life estate-remainder dispositions implicitly recognized a problem that would become apparent when, in 1942, Congress enacted legislation that expanded significantly the taxation of property subject to powers of appointment. So long as the expiration of life estates did not constitute a taxable transfer, those seeking to avoid tax on intervening generations would, at the sacrifice of the flexibility provided by the special power, channel their dispositions into the more rigid life estate-remainder mold.

As stated above, in 1942 Congress enacted legislation to expand the taxation of powers of appointment which it had found to be "an outstanding device for the avoidance of estate tax."²⁴ Under the 1942 law every power of appointment, with two major exceptions, resulted in the inclusion in the holder's estate of the property subject to the power. Those powers excepted were: (1) a power to appoint within a class which included no others than the spouse of the decedent, spouse of the creator of the power, descendants of the creator of the power (other than the holder), descendants of the decedent or of his spouse, spouses of such

968 (1939).

²⁴H. Rep. No. 2333, 77th Cong. 2d Sess. 160 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 232 (1942).

descendants, and charitable organizations; and (2) a power to appoint within a "restricted class" where the holder of the power received no beneficial interest, either vested or contingent, in the property.

Lawyers expressed immediate dissatisfaction with the 1942 amendments. They argued that the new statute was "complex and tended to force property dispositions into narrow and rigid patterns;"²⁵ that so long as the donee of a power could not exercise a power on his own behalf there was no reason to exempt a power exercisable in favor of spouses, descendants and charities while taxing it if exercisable in favor of others; and that the scope of the exemption for fiduciary powers exercisable among a "restricted class" was too vague to provide adequate planning standards.²⁶ The Bar argued that only powers exercisable in favor of the holder, his creditors or his estate should be taxed because only in that case does the power-holder possess the equivalent of outright ownership of the property. In the Powers of Appointment Act of 1951 Congress accepted these arguments and revised retroactively the tax treatment of powers of appointment.²⁷ Only powers

²⁵Craven, "Powers of Appointment Act of 1951," 65 Harv. L. Rev. 55, 61 (1951)

²⁶*Id.* at 62.

²⁷H. Rep. No. 327, 82d Cong. 1st Sess. (1951); S. Rep. No. 382, 82d Cong. 2d Sess. (1951).

exercisable in favor of the holder, his creditors, his estate or creditors of his estate were taxable powers and then only if the power was not exercisable pursuant to a statutorily defined standard, in conjunction with the creator of power or with one who has an interest in the property subject to the power adverse to that of the power-holder.

C. The Studies of the 1960's.

1. The American Law Institute Recommendations.

In 1961 the American Law Institute returned to its abandoned study of transfer taxation. In his 1961 Report on Possible Work by ALI in Federal Estate and Gift Taxation, Professor Casner tied together for the first time the life estate-remainder and power of appointment strands as but two aspects of the same issue--skipping transfers. After outlining two dispositive schemes under which persons who happened to be in intervening generations possessed both a non-taxable economic interest in the transferred property and a non-taxable power to control its ultimate devolution, Professor Casner noted the following policy issues.

A policy determination might be made to treat a beneficiary under a disposition as the owner of the transferred assets for gift and estate tax purposes when he is given a power to affect their devolution, either during his lifetime or on his death. The effectuation of such a policy decision, if nothing more were done, would most likely result in the vesting of the power to change family dispositions in one outside the family. The likelihood is that this would not be in the best interests of the family.

A policy determination might be made to

attribute a power not held by a beneficiary to the beneficiary and to treat the beneficiary as the owner for gift and estate tax purposes of the property subject to the power attributed to him. The drafting of a statute to carry out such a policy would not be an easy task because powers given to one other than a beneficiary . . . are frequently spray powers and the statute would have to spell out the applicable rule for determining to which one or ones of the possible beneficiaries the trustee's powers would be attributed for gift and estate tax purposes. . . .

The imposition of gift and estate tax burdens on one or more beneficiaries whenever flexibility is introduced in the dispositive plan would tend to force long-range family dispositions into a fixed and rigid mold, certainly an undesirable result so far as the family is concerned, unless something were done to eliminate the federal estate tax advantage of creating successive life interests. A policy determination could be made, as was made in England, to include in the gross estate of a life beneficiary the value of the property in which his life interest exists. The freak family dispositions that would then be devised to avoid the successive impositions of estate taxes would depend on the hole left by the statute designed to carry out such policy determination. For example, in drafting such a statute, it would have to be kept in mind that beneficial rights can be shifted from one person to another on the happening of many events unassociated with death and the gift and estate tax consequences of such shifts, as well as a shift on the death of a beneficiary, would have to be considered if the policy behind the statute were to be effectuated.²⁸

The Reporter and Consultants met in September of 1961 to define the objectives to be attained by an estate and gift tax law. Emerging from that meeting was the conclusion that the existing statute was unsatisfactory because, among other things, "[i]t permits substantial wealth to move from generation to

²⁸American Law Institute, Report on Possible Work by ALI in Federal Estate and Gift Taxation 27-29 (February 15, 1961).

generation without the imposition of any tax."²⁹ The first effort to cure this defect, set out in a memorandum dated November 9, 1962, to the ALI Council, was an expansion of the concept of ownership for transfer tax purposes.

Under the proposed new law, the holder of a limited present interest in property is treated as the owner of the entire property for transfer tax purposes, so that he is treated as transferring the entire property whenever his limited present interest ends or is disposed of by him. . . .

This imputed ownership rule has been adopted to prevent tax avoidance in this area for the period of the rule against perpetuities . . . and to eliminate the present predominance of the tax factor in the selection of the form of family dispositions. . . .

One of the objections to the present law . . . is the length of time a body of wealth can be removed completely from the realm of gift and estate taxation by the establishment of a succes-

²⁹American Law Institute, Proposed Framework for Federal Estate and Gift Tax Law 1 (November 9, 1962). The other listed shortcomings were that the transfer tax:

- (1) was too complex
- (2) caused family dispositive arrangements to be dictated by tax avoidance considerations
- (3) gave favored tax treatment to certain kinds of property
- (4) did not give sufficient encouragement to the movement of the control of wealth from the older to the younger generation
- (5) was controlled in its operation too often by local law, thus causing differences in Federal tax consequences in similar factual situations
- (6) retained too many differences in treatment between community property states and common law states.

sion of interests all within the allowed period of the rule against perpetuities. This same objection could be leveled at the new law if it were possible to place property in a mandatory accumulation trust and make it untouchable for the period of the rule against perpetuities and then have the principal and accumulation move out to designated beneficiaries without any transfer tax attaching throughout this period. The rules which would impute ownership to persons enjoying limited interest from time to time would not cover this situation. Thus, the new law would impose a tax on such mandatory accumulation trusts once every 20 years ³⁰

Conforming changes were also suggested with respect to the treatment of powers of appointment in order to protect the imputed ownership rule in orthodox life beneficiary cases.

If the power-holder has the power alone to vest the property subject to the power in himself, his estate, his creditors or creditors of his estate, either immediately or by his will, the power-holder is regarded as owning presently the property subject to the power. . . .

In situations where the power-holder would not be regarded as the owner of the property subject to the power, the power in order to be significant must be one which can be presently exercised to affect the current beneficial enjoyment of the property subject to the power. In such case, however, the tax significance will not be to cause the ownership of the appointive property to be attributed to the power-holder but will be to cause the ownership of property to be imputed to the objects of the power. . . . This imputed ownership result is necessary in order to prevent the avoidance of the imputed ownership rule previously considered where a life beneficiary was treated as the owner of the entire interest in which his life interest exists.

The discretionary trust so widely employed today is the principal example of a power which can be presently exercised to affect the current beneficial enjoyment of the property subject to

³⁰ *Id.* at 8, 9, 13-14.

the power. A transfers property to T to hold in trust and give T the power to pay out the income to B or to accumulate the income. On B's death, the trust property is to be distributed to designated beneficiaries. In this case, the ownership of the property must be attributed to B under the new law, so that on his death he will be treated as though he made a transfer thereof to the corpus beneficiaries, or otherwise this form of disposition would become the standard method to avoid the orthodox imputed ownership case where B is a straight life beneficiary. The new law assigns to B's interest under the discretionary trust a new name for the purpose of convenient reference. The new name is a "contingent present interest" to distinguish it from the case of the orthodox life beneficiary.

The contingent present interest situation becomes more complex when the trustee has discretion to spray the current beneficial enjoyment among a group or accumulate the income. In this situation, the first to die of the group will be treated as the owner of a portion of the trust property, such portion to be determined by a look backward to see in fact what portion of the current benefit he has enjoyed and what portion has been withheld from enjoyment by anyone by virtue of accumulations. The deceased member of the group will be regarded as the owner of that portion of the trust property that corresponds to the portion enjoyed by him plus the portion withheld completely from enjoyment by others.³¹

The attempt to tie the taxation of skipping transfers into the existing estate and gift tax structure through an imputed ownership concept was soon abandoned and a supplementary "successions" tax explored. The successions tax, in general, treated the movement of current beneficial enjoyment of transferred property as a taxable event so long as that movement had not been subject to estate or gift tax. Thus the termination of a life estate or term of years was subject to succes-

³¹ *Id.* at 33-36.

sions tax as was the termination of the status as a permissible appointee under a special power of appointment held by another. The successions tax was also rejected as a solution, principally because the tax structure became extremely complex.³²

The next alternative, a form of which was ultimately adopted by the Institute, was an additional tax on the transfer of a limited interest in property. In developing the parameters of the additional tax the most crucial question was the definition of the transfers to which it would apply. There were two aspects to this question. First, to what extent should skipping transfers be permitted? Second, should the form of the transfer affect the tax treatment?

In his Reporter's Study, Professor Casner commented as follows:

The effect of the imposition of an additional tax on various types of included transfers is likely to be that dispositive arrangements will be so drawn that the additional tax will be avoided. If a particular disposition falls on the additional-tax side of the line, either through ignorance, mistake or even design, the opportunity to move the disposition over to the other side of the line and avoid the additional tax will be allowed up to the time the additional tax is due and payable, if the controlling local law permits such a change in the beneficial rights under the disposition.

The location of the line between additional-

³²The successions tax proposal was set forth at American Law Institute, Federal Estate and Gift Taxation 351-410 (1968) [hereinafter cited as "ALI Recommendations"].

tax dispositions and non-additional-tax dispositions is influenced by one's view as to the period of time that should be allowed to elapse between the imposition of a transfer tax on particular property, and one's view as to the types of family dispositions that should not be discouraged. Balancing these two considerations has led to a variety of views in regard to the location of the line, with almost everyone agreeing that the line should be drawn at some point. Set out below are various alternatives, starting with one that draws the line at a point that includes in the category of additional-tax dispositions more transfers than any other alternative. Each of the subsequent alternatives in order narrows the field of additional-tax dispositions.

Alternative No. 1:

An included transfer is subject to the additional tax unless no interest passes under the transfer to a person other than one who is one degree lower than, or in the same degree as, or in a higher degree than, the transferor.

* * *

Alternative No. 2:

An included transfer is subject to the additional tax unless no interest passes under the transfer to a person other than one described under Alternative No. 1, and other than to a child of a person one degree lower than the transferor, if such parent is deceased on the date of the transfer.

* * *

Alternative No. 3:

An included transfer is subject to the additional tax unless no interest passes under the transfer to a person other than one described under Alternative No. 1, and other than to a child of a person one degree lower than the transferor, whether or not such parent is deceased on the date of the transfer.

* * *

Alternative No. 4a:

An included transfer is subject to the additional tax unless on the date of the transfer, or

not later than the death of a beneficiary under the transfer who is in the same degree as, or in a higher degree than, the transferor, outright ownership or its equivalent passes to some person.

Alternative No. 4b:

An included transfer is subject to the additional tax unless on the date of the transfer, or not later than the death of a beneficiary under the transfer who is one degree lower than, or in the same degree as, or in a higher degree than, the transferor, outright ownership, or its equivalent passes to some person.

* * *

Alternative No. 5:

An included transfer that would be subject to the additional tax under Alternative 4b will nevertheless be excluded from such tax, if the only shift in beneficial ownership that can occur after the deadline set in 4b is a shift due to the death of a beneficiary under 21.

* * *

Alternative No. 6:

This Alternative is the same as Alternative No. 5, except that the interest in a beneficiary could be contingent on his attainment of the age of 25 or possibly 30.³³

The members of the American Law Institute adopted Alternative No. 4b as the inclusion rule. The specific recommendations with respect to the skipping issues were:

[1] . . . [A]n additional tax should be imposed to deal with the problem of the avoidance of transfer taxes by a succession of limited beneficial interests that may continue through several generations.

[2] . . . [A]n additional tax should not be imposed on an outright transfer, or its

³³Id. at 169-177.

equivalent.

[3] . . . [T]he additional tax should be applicable to the transfer of a limited interest if, but only if, distribution of benefits may be made under the transfer to a person more than one generation below the transferor at a time subsequent to the death of a person one generation below the transferor.

Such additional tax should be: (a) imposed at the average rate applicable to all transfers by the transferor in the taxable period of the transfer, (b) imposed at the time of the transfer or at the time of distribution to a person more than one generation below the transferor, as the transferor or his personal representative may elect, and (c) collectible only out of the property on which the additional tax is imposed, unless the transferor specifies other funds out of which the additional tax is to be paid.³⁴

Under the ALI recommendations, therefore, many single-generation skips would not be subject to the additional tax. In addition, direct transfers were not subject to the tax. Thus, in terms of the criteria and data discussed in the text, the ALI proposal would not have reached the great majority of generation-skipping transfers in trust. Moreover, by exempting direct transfers the proposals created an incentive for tax conscious transferors to forego the non-tax advantages of split-interest trust dispositions to achieve the tax minimization afforded by direct transfers.

2. The 1969 Treasury Department Tax Reform Studies and Proposals.³⁵ The Treasury Department had

³⁴Id. at 30-31.

³⁵U.S. Department of the Treasury, Tax Reform Studies and Proposals 393-401 (1969).

likewise been studying the skipping issue and, as part of its 1969 Tax Reform Proposals, defined the problem in the following terms and proposed the following solution:

* * *

The ability to skip generations causes an inequitable distribution of the transfer tax in that some families are required to pay a transfer tax at each generation as the family wealth moves from generation to generation in the normal fashion, while other families avoid the tax at some generations. This situation unfairly discriminates against those persons of relatively modest wealth who cannot avail themselves of the opportunity to skip a tax, as well as against all persons regardless of wealth who for personal family reasons do not desire to make use of these generation-skipping arrangements despite the tax savings. It leads to all individuals, in determining how to distribute their wealth and care for their survivors, having to choose between personal and family considerations, on the one hand, and tax savings on the other. A fair tax system would not demand this choice.

PROPOSAL

The basic objective of the proposal is to obtain a transfer tax with respect to each generation regardless of whether that generation receives the property or is skipped in favor of a succeeding generation. Thus, a substitute tax would be imposed if property is transferred, by gift or bequest, so that it will be received by the transferor's grandchild, or any other person who is more than one degree in family relationship below the transferor, without the payment of a transfer tax by the intervening generation under the normal procedure. In the case of a transfer to a person unrelated to the transferor, the transferee would be considered more than one degree below the transferor, if he is more than 25 years younger than the transferor. The substitute tax would apply whether the transfer is in the form of an outright gift or through a trust.³⁶

³⁶Id. at 389.

* * *

The Treasury proposal, reached both single generation-skipping transfers and direct generation-skipping transfers. Under the Treasury proposal, there were two methods to calculate the tax due. First, a tax, normally equal to 60 percent of the value of the generation-skipping transfer, could be paid by the transferor at the time of the transfer. However, an election was permitted to allow the tax liability to be determined as if the property had actually passed through and been a part of the tax base of the skipped generation.

3. The Jantscher Successions Tax. Writing in 1966, Gerald Jantscher proposed a form of successions tax as the solution to the skipping problem. Jantscher believed that

whether or not the . . . loss in tax collections through the use of trusts threatens the vitality of the estate and gift taxes, the creation of generation-skipping trusts by a minority of decedents invites careful attention. The problem seems fundamentally one of equity. The estate tax schedule reflects a consensus that the rates of tax upon large accumulations of wealth should be higher than upon smaller accumulations . . . The use of generation-skipping trusts by a minority of wealthy decedents tends to frustrate this objective of the estate tax.³⁷

Jantscher sought a solution to this equity problem within the parameters of the existing estate and gift tax structure rather than through the creation of an

³⁷ Jantscher, supra note 3, at 157-158.

additional or supplementary tax. Jantscher's general rule for taxation was as follows:

Upon the expiry in year T_e of a beneficiary's interest in trust property, a fraction of the trust corpus is to be held liable to tax. This fraction is defined as the ratio of the value of payments from current income that were made to the beneficiary in the years between T_m and T_e to the sum of the value of all current income from the corpus that had been distributed to any and all beneficiaries between the same years and the full value of the corpus at the beginning of year $T_e + 1$. All values are to be discounted back to their corresponding value as of year T_m , using a fixed rate of discount. T_m is identified as that year in which the present value of all remaining payments to the beneficiary is maximized.³⁸

Jantscher's proposal was specifically designed "to complete a system of taxation that aims to tax the gratuitous transfers of the enjoyment of property."³⁹ (emphasis added) Thus his proposal did not directly encompass the treatment of property subject to a power of appointment. Nor did it attempt to impose any additional tax on a direct generation-skipping transfer. He recognized that testators might react to the imposition of such a tax by curtailing trust dispositions in favor of outright transfers. However, he did not believe that the practical effect of permitting direct generation-skipping would be significant.

D. The 1973 Ways and Means Committee Hearings.
Transfer tax issues were discussed briefly in the hearings which preceded the Tax Reform Act of 1969.

³⁸Id. at 177-178.

³⁹Id. at 160.

However, it was not until 1973 that Congress showed any significant interest in transfer tax reform. In 1973 the Ways and Means Committee held panel discussions on tax reform in general and specifically invited a number of individuals to address, as a panel, the issue of estate and gift tax revision. The panelists invited to discuss generation-skipping agreed, in general, that generation-skipping transfers were a problem. However, there was no unanimity either as to the precise definition of the problem or solutions to it.⁴⁰

The 1969 Treasury proposal was defended by Dr. Gerrard Brannon who, anticipating criticism on the grounds of complexity argued that a complex statute is necessary to deal adequately with complex dispositions. Dr. Brannon also noted that the blanket taxation of all generation-skipping transfers, no matter what their form or duration, was necessary to preserve the neutrality of the tax system. Others disagreed. First, the Treasury proposal was perceived as too complex. Second, it was thought too extreme in taxing outright transfers and not exempting a single generation skip. The latter criticism had its basis in a number of conflicting philosophies; some questioned the

⁴⁰General Tax Reform: Panel Discussions Before House Comm. on Ways and Means, 93d Cong., 2d Sess. reprinted in Staff of Comm. on Ways and Means, Background Materials on Federal Estate and Gift Taxation, 94th Cong., 2d Sess. 69-182 (Comm. Print 1976).

premise that transfer tax ought to be imposed at least once a generation; others indicated that a preference ought to be accorded "family" dispositions, at least to the extent that only a single generation was skipped; and still others thought the proposal should be confined only to those dispositions in which benefits from the transferred property were split between two generations. Third, it was asserted that the tax was imposed by reference to the wrong transferor (e.g., the rate should be determined by reference to the transfer tax profile of the skipped generation, not the original transferor). Fourth, the election mechanism was alleged defective in creating, in effect, a lottery aspect to the tax payment.

The panelists agreed that a statutory structure to deal adequately with the generation-skipping would be complex and that the level of complexity would increase as the solution attempted to replicate the tax results that would have occurred had the property involved actually been included in the transfer tax bases of the intermediate generations. Recognizing these problems, a number of alternative solutions were proposed:

1. Expand the taxability of property subject to a power of appointment.⁴¹ This solution, attempted and rejected once before, would leave untouched the life estate-remainder disposition.

⁴¹Id. at 77 (statement of Marvin Collie).

2. Impose an additional tax on certain long term trust dispositions.⁴² An additional tax would be applicable to long term trusts where the property does not vest in a child or grandchild at a time no later than the death of the last living child of the transferor. The tax would be paid from the trust property and would be determined by including the trust property in the transfers of the "skipped" generation. This suggestion, like that of the ALI, would permit direct transfers and single generation skips. It differed from the ALI proposal in determining the tax by reference to the tax base of the skipped generation rather than that of the original transferor.

3. Confine the Treasury substitute tax to trusts which skip more than one generation.⁴³ This proposal would confine the complex statutory structure necessary adequately to police generation-skipping transfers to trusts which skip more than one generation. Trusts which skip a single generation would be taxed as under current law but an outright transfer to a child of the transferor would be partially deductible. The amount of the deduction would be calculated so that the tax burden borne by the transferor and the child would equal the tax burden borne by the transferor of

⁴²*Id.* at 135 (statement of Richard Covey).

⁴³*Id.* at 118-122 (statement of David Westfall).

property to a trust which skips a single generation. It should be noted that the same result could be reached by surcharge on amounts placed in single generation-skipping trusts.

E. The 1976 Ways and Means Committee Hearings.

The generation-skipping issue was revisited in depth by the House Ways and Means Committee in its 1976 Hearings on Estate and Gift Taxes. Again, a panel of invited experts agreed there was a problem, but disagreed on the appropriate solution.⁴⁴

The American Bankers Association presented its most current version of a transfer tax to be imposed upon the termination of a limited interest in trust property by treating the trust property as having been transferred by the beneficiary of the limited interest.⁴⁵ However, shifts among the family of the transferor would not be taxable events. For this purpose, family included spouses, children and grandchildren but not great grandchildren.

The American Institute of Certified Public Accountants agreed that generation-skipping posed a transfer tax problem and proposed a solution which would have permitted outright generation-skipping transfers and would have treated a trust as subject to transfer tax

⁴⁴Federal Estate and Gift Taxes: Hearings Before House Comm. on Ways and Means, 94th Cong., 2d Sess. 1332-1447 (1976).

⁴⁵*Id.* at 159-185.

at the time the beneficial interest of an intervening generation beneficiary expired.⁴⁶ At that time an amount equal to the actuarial value of the interest of the intervening generation (determined by reference to the date of the creation of the trust) would be treated as an additional taxable transfer by that beneficiary with the tax so determined to be paid from the trust corpus. Special rules were provided for the determination of the amount of the taxable transfer when discretionary trusts were involved.

F. The Tax Reform Act of 1976--The Enactment of Chapter 13. Chapter 13, The Tax on Certain Generation-Skipping Transfers, was enacted as part of the Tax Reform Act of 1976. In acting to close the tax advantages available through generation-skipping, Congress stated that the new tax was necessary: (a) to assure that the transfer tax applies to taxpayers as nearly as possible on a uniform, generation by generation basis, (b) to reduce the relative tax advantages that generation-skipping afforded to wealthier families, (c) to restore progressivity to the process of wealth transmission, and (d) to restore neutrality in the tax treatment of wealth transfers so that there would be no tax advantage in setting up trusts.⁴⁷

⁴⁶Id. 313-315.

⁴⁷Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong.,

The structure chosen to accomplish these aims was principally that advocated by the American Bankers Association. The new tax was imposed on a "wait and see" basis upon the distribution of property from or termination of an interest in a trust or trust equivalent in which the benefits of the transferred property were split between two or more generations of beneficiaries assigned to generation levels below that of the transferor. Thus the tax did not affect outright generation-skipping transfers, nor did it affect trust dispositions for the benefit of members of a single generation more than one generation below the transferor if no member of an intervening generation had an interest or power. Subject to a \$250,000 exclusion per grandchild of the grantor, the tax applied to single generation skips.

In general, the tax was designed to replicate the result which would have occurred had the property in question actually been transferred outright from generation to generation. Mechanically, this result was accomplished by treating a taxable generation-skipping transfer as a transfer made by a "deemed transferor;" the tax due would be computed by reference to the transfer tax profile of the deemed transferor at the time the taxable transfer was made and in general

2d Sess. 564-565 (Jt. Comm. Print 1976).

the tax so determined was payable out of the transferred property.

There were two types of taxable generation-skipping transfers; taxable distributions and taxable terminations. Again speaking generally, a taxable distribution was a distribution (other than from current income) from a generation-skipping trust to a beneficiary more than one generation below the grantor of the trust. A taxable termination was, in general, the termination of any present interest in or power over a generation-skipping trust possessed by a beneficiary assigned to a generation below that of the grantor so long as at that time there existed a beneficiary with an interest in the trust who was assigned to a generation below that of the beneficiary whose interest had terminated. However, holders of certain circumscribed powers were not treated as possessing powers. Distributions of current trust income were not treated as taxable distributions. An exclusion was provided for the first \$250,000 of otherwise taxable transfers to each grandchild of a grantor of a generation-skipping trust.

Since its enactment, Chapter 13 has been highly criticized; most agree the tax has proved administratively unworkable; some believe it does not go far enough in eliminating the tax advantages created by generation-skipping transfers; others assert it has

created its own set of inequities and incentives.⁴⁸ The criticisms are set out below for evaluation in the context of the normative criteria suggested in Part II:

1. Equity. Chapter 13 is biased in favor of the most wealthy taxpayers. Only they can afford to make direct generation-skipping transfers, either outright or to a trust in which there is no intervening generation with a present interest or power ("layering" dispositions). This is, of course, a valid (and ironic) criticism. One purpose of the enactment of Chapter 13 was to reduce the relative advantage that wealthy individuals, who could afford to make dispositions in trust, had over those who did not have sufficient resources to make trust dispositions. The effect of Chapter 13 is perpetuate this tax advantage for the "super wealthy" to the disadvantage of those who, while able to make trust dispositions, do not have sufficient wealth to engage in "layering" dispositions.

Apart from the bias accorded those who can afford to "layer" their dispositions, Chapter 13 retains a number of elements which favor those of who make trust dispositions in which interests are split between generations over those who do not. The "grandchild exclusion" permits tax-free single generation skips for

⁴⁸See generally, Additional Estate and Gift Tax Issues: Hearings Before the Sen. Fin. Subcomm. on Estate and Gift Taxation, 97th Cong., 1st Sess. 37-53, 111-281 (1981).

those who would otherwise be subject to the tax in contrast to the treatment of property which passes outright from generation to generation. The exception for power to appoint among lineal descendants of the grantor permits members of intervening generations to direct the ultimate disposition of property placed in trust without the imposition of the tax. The current income exception likewise permits trust property to be distributed in a tax-free generation-skipping transfer. Thus the structure of Chapter 13 does not conform precisely to the legislative purpose of assuring the taxation of property once a generation. Moreover, these avoidance techniques have been widely noted at seminars and continuing legal educations with the result that many practitioners have become aware of their existence and have learned how to draft instruments to utilize them effectively.

2. Neutrality. Chapter 13 does not remove differences in tax treatment attributable solely to the form of the disposition. First, outright transfers are treated differently than transfers to generation-skipping trusts. Second, transfers in trust are not subject to Chapter 13 if no intervening generation has a present interest in or power over the trust. Thus, tax minimizing transferors are induced to tailor their dispositions to achieve tax exempt status despite the fact that they might otherwise desire the flexibility of a discretionary trust for non-tax reasons.

3. Administrability. Chapter 13 has created administrative problems at a number of levels.

a. Statutory Complexity. Chapter 13 seeks to replicate the treatment of outright intergenerational property dispositions, but only if, on a "wait and see" basis, a generation-skipping transfer (as defined) actually occurs. This goal of precision--taxing only transfers which are generation-skipping, as that term is defined, at the time such transfers occur and at a rate determined by reference to the transfer tax profile of an appropriate individual in the intervening generation--is, of course, desirable. However, the statutory structure necessary to accomplish this goal is complex. Rules are required to define the time at which a generation-skipping transfer occurs and to identify the individual (the "deemed transferor") whose transfer tax profile is to be used in determining the amount of tax due.

A second layer of statutory complexity is added once the decision is made to exempt certain types of generation-skipping transfers from the ambit of the tax. Once outright generation-skipping transfers are exempted from the tax, it is claimed that direct transfers in trust in which no intervening generation has an interest or power should likewise be exempt. Thus rules must be devised to determine the circumstances under which intervening generations will be treated as

having a sufficient interest in the trust to have it treated as a generation-skipping trust. A line must be drawn somewhere, and once it is accepted that the intervening generation may participate in the administration of the trust without triggering generation-skipping transfer consequences, it becomes very difficult to draw a line that is both simple to administer and defensible on policy grounds. Indeed, one need only look to the legislative history of the tax treatment of powers of appointment under the estate and gift tax to be reminded of the difficulty of establishing this line and the complexity that results once artificial distinctions are made in the name of preserving flexibility.

Quite apart from the complexity that results from the need to determine whether an intervening generation possesses an interest in a generation-skipping, is the question of defining the parameters of other exclusions from the ambit of the tax. Thus rules are necessary to define and limit the scope of both the grandchild exclusion and the current income exception.

b. Administration and Compliance. Chapter 13 also raises difficult problems of administration and compliance from the viewpoint of both taxpayers and the Internal Revenue Service. Chapter 13 has been in effect for seven years. Yet no final regulations have been promulgated, nor was a return finalized until June of 1982. In this atmosphere, it is difficult for

practitioners to anticipate correctly the impact of the tax. Obviously they have also been unable to comply with the nominal reporting requirements. To be sure, while the problems of lack of adequate administrative guidance may be cured over time, significant costs are incurred in the interim. Moreover, even if the rules of the game are clarified, it is unlikely as a practical matter that either taxpayers or the Service will have the information necessary to assure accurate filing and audit of generation-skipping tax returns. The need to identify a "deemed transferor" and quantify his transfer tax base creates significant administrative problems in addition to those which arise simply due to the need for interpretative guidance.

4. Summary. It is fair to say that the experience under Chapter 13 has been unsatisfactory. While the statute reduces the tax advantages of generation-skipping transfers for many taxpayers it leaves open avoidance opportunities for others, thus raising equity and neutrality concerns. Moreover, its complexity gives rise to serious interpretative, administrative and compliance problems which raise transactions costs to a level viewed by many as unacceptable.

G. The 1983 Treasury Proposal. On April 29, 1983 the Treasury Department sent to Senator Symms, Chairman of the Senate Finance Subcommittee on Estate and Gift

Taxes, a proposal to replace existing Chapter 13. The Treasury proposal is set forth in the text.

Treasury concluded that there is no principled way to adapt Chapter 13 to the overriding tax policy goals of equity, neutrality and administrability. Therefore it recommended that subject to a \$1,000,000 per transferor exemption, all generation-skipping transfers, whether outright or in trust, be subject to a flat rate tax of 80% of the maximum marginal transfer tax rate in effect at the time of the transfer. Outright transfers would be taxed at the time of the transfer. Transfers in trust would be taxed on a "wait and see" basis. Treasury's reasons for recommending this approach and its analysis of the consequences of its proposal are stated in its recommendation and will not be repeated here.

H. The British System. An exposition of the alternative methods available to deal with the skipping issue would not be complete without a brief description of the British Capital Transfer Tax.⁴⁹ Under the current version of the Capital Transfer Tax outright generation-skipping gifts are not subject to any additional tax other than that applicable to lifetime or deathtime transfers of the transferor. However,

⁴⁹See generally, Ind, Capital Transfer Tax (2d ed. MacDonald and Evans 1981); Pinson, Revenue Law (13th ed. Sweet and Maxwell 1980); Inland Revenue, Capital Transfer Tax and Settled Property: A Consultative Document (August 1980).

transfers in trust, in addition to being subject to capital transfer tax upon their creation, are subject to additional capital taxes at various times depending upon the type of trust created.

Where a trust has a life beneficiary or other beneficiary with an interest in possession (the right to demand all or a part of the income of the trust), capital transfer tax is imposed upon distributions of trust corpus and the disposition or termination of the life interest or interest in possession. Distributions of corpus to the person with an interest in possession are not taxable. The person entitled to the income is treated as the owner of the trust property.

Accordingly, the transfer tax profile of the person possessing the income interest is used to determine the tax liability which is paid from the trust property.

Where a discretionary trust (a trust in which no person has an interest in possession) has been created, capital transfer tax is levied upon the creation of the trust. Since there is no individual who can be treated as the owner of a discretionary trust, the trust is made a separate taxpayer, with its own cumulative rate schedule applicable to taxable transfers. After creation, so long as and to the extent that the trust is not subject to an interest in possession, capital transfer tax is levied periodically on the tenth anniversaries of the creation of the trust. A propor-

tionate charge, based on the time that has elapsed since the last ten year charge, is levied at the time property is distributed from the trust.

It should be noted that the capital transfer tax goes well beyond addressing generation-skipping problems. The expiration of life estate of a beneficiary in the same generation as the transferor is taxable as are distributions from discretionary trusts to beneficiaries in the same generation as the settlor. Exceptions are provided for distributions to spouses and to children who obtain an interest in possession or absolute ownership of trust property before reaching the age of 25.

I. A Supplementary Accessions Tax. As noted earlier, skipping transfers could be subject to a tax imposed on recipients and based on cumulative skipping accessions. This tax would be independent from the existing transfer tax. The Reporters have not attempted to develop the framework of a supplementary accessions tax. However, if this avenue were to be pursued, the starting point for the development of such a tax would be Professor Andrews' study of an Accessions Tax set forth in the 1968 American Law Institute Estate and Gift Tax Recommendations.⁵⁰

⁵⁰1968 ALI Recommendations, supra note 32, at 446.

Appendix DPart I. The 1983 Treasury Department
Generation-Skipping Tax ProposalSimplification ProposalGeneral Explanation

The overriding objective of this proposal is to replace the present generation-skipping transfer tax with one which is considerably simpler than the present tax and which has potential application to a much smaller number of individuals, but which also is fairer and more effective than present Chapter 13. While some of the mechanical rules in the present statute would be retained with little or no modification, the proposal is not simply an attempt to "patch up" some of the problem areas in the existing Chapter 13. It represents a fundamentally different and far simpler approach to the problem of generation skipping.

The proposal aims to achieve its objective by making three fundamental changes in the generation-skipping transfer tax system.

Exemption of \$1,000,000 Per Grantor

First, every individual will be permitted to make transfers aggregating as much as \$1,000,000, during lifetime and at death, which will be wholly exempt from the generation-skipping transfer (GST) tax. Lifetime transfers that qualify for

gift tax exclusion also would be excluded for GST tax purposes. The exclusion in present Chapter 13 for transfers to the grantor's grandchildren of \$250,000 per deemed transferor would be eliminated.

Under the new \$1,000,000 per transferor exemption, a married couple with a combined estate of \$2,000,000 or less can easily plan their estate so that their property will not be subject to the generation-skipping transfer tax at all. This change also will restrict the GST tax to the domain of the wealthiest families, where generation skipping is most prevalent and results in the largest revenue losses.

Flat Rate Tax on Non-Exempt Transfers

Second, generation-skipping transfers not covered by the \$1,000,000 exemption would be taxed at a flat rate equal to 80 percent of the highest estate tax rate in effect at the time of the transfer. This means that for taxable generation-skipping transfers after 1984, the tax rate will be 40 percent.

A flat rate will greatly simplify the administration of the GST tax system. No information regarding deemed transferors will need to be stored and retrieved, and computation of the tax will be relatively straightforward.

The shift to a flat rate tax will not be unfair to taxpayers with moderate-sized estates. The combination of the \$1,000,000 exemption and the 40 percent rate will assure that the GST tax payable on a generation-skipping transfer will almost always be less than the estate or gift tax which would have been payable had the property been passed through the skipped generation. Also, the benefits of the \$1,000,000 exemption will generally outweigh any benefits available under the present system from the \$250,000 exclusion for transfers to grandchildren.

The 40 percent rate may provide some tax savings to the wealthiest families, since they will be able to use generation-skipping transfers to transfer property to lower generations at tax rates below the highest estate tax rate. However, a GST tax with a flat rate equal to 80 percent of the top estate tax rate leaves much less incentive for the wealthiest taxpayers to use generation-skipping arrangements than would an outright repeal of Chapter 13.

Taxation of All Generation-Skipping Transfers Not Covered by the \$1,000,000 Exemption

Third, subject to the \$1,000,000 exemption given each transferor and the other exclusions noted above, the proposal would apply a generation-skipping transfer tax to property when all interests in the property are transferred to or held for the benefit of recipients at least two generations below that of the transferor without the payment of estate or gift tax in an intervening generation. Thus, the GST tax would apply immediately to outright transfers to any person two or more generations below the transferor and to any transfer in trust for the exclusive benefit of one or more such beneficiaries. However, transfers to trusts where a member of the grantor's generation or the generation of the grantor's children has an interest would not be subject to immediate tax. As under present law, the tax in that case would be postponed until actual distributions are made to lower-generation beneficiaries or until all interests in the higher generations terminate, at which time the tax would be imposed on the value of the distributed property or the value of property remaining in the trust. Unlike the present GST tax, though, the proposed GST tax would not provide an exclusion for income distributions. Instead, an income tax deduction would be provided for the GST tax imposed on such income distributions.

Because of the \$1,000,000 per transferor exemption and the GST exclusion for lifetime transfers covered by gift tax exclusions, this approach would leave every person free to make substantial gifts or bequests to his or her grandchildren (or any other individual) without the payment of a GST tax at any time. On the other hand, all generation-skipping transfers not covered by the exemptions will be subject to the GST tax. This is an appropriate result since the GST tax is not a penalty on generation-skipping transfers. It merely serves to reduce the bias in favor of generation-skipping transfers inherent in the Federal estate and gift tax system.

Making all generation-skipping transfers subject to Chapter 13 will greatly simplify the GST tax. Under the proposal, it will no longer be necessary to determine if a younger generation beneficiary in a generation higher than some other younger generation beneficiary has an interest or power in a trust sufficient to make it a generation-skipping trust. As a consequence, the "power" rule of present Chapter 13 would be unnecessary. Whether an arrangement is a "trust equivalent" would no longer be relevant, and the concept of the "deemed transferor" would be eliminated.

Technical Explanation1. Definition of Generation-Skipping Transfer

The proposal would impose a GST tax on all noncharitable transfers which result in the avoidance of the estate and gift tax in one or more generations below that of the transferor. Exceptions are provided, however, for gifts excluded from tax under sections 2503(b) and (e) of the Code and for transfers covered by the \$1,000,000 exemption described in section 2 below. An outright gift or bequest, or a transfer in trust where no person in a generation above that of the second generation below the grantor has an interest in the trust, would be subject to GST tax at the time of the transfer. For other transfers in trust, the GST tax would be postponed until actual generation-skipping distributions are made or until the termination of all interests of individuals assigned to generations above the second generation below the grantor. If the trust does not transfer property to a beneficiary two or more generations below the grantor, no GST tax would be payable.

The taxation of direct generation-skipping transfers is an essential part of the proposal for two reasons. First, if all generation-skipping transfers above the \$1,000,000 exemption are subject to the GST tax, the tax cannot be avoided by "layering" techniques that pass property, either in trust or outright, directly to the second, third or fourth generation below the transferor. This will eliminate the bias in the current GST tax in favor of the wealthiest families as compared with families of more modest wealth, making the tax fairer and more effective. Second, the comprehensive approach that taxes all generation-skipping transfers not covered by the \$1,000,000 exemption or gift tax exclusions has the virtue of simplicity. Any other approach necessarily involves drawing a line between trusts and trust equivalents which are subject to tax and those which are not. This inevitably leads to statutory complexity, which in turn leads to planning difficulties. Only a comprehensive statute can be drawn in a simple and easily understandable way. Finally, a comprehensive statute makes planning easier. Since the GST tax cannot be avoided by certain forms of transfer, the estate planner is no longer in a position to suggest unusual arrangements (such as layering) to save transfer taxes in later generations. Accordingly, tax considerations will be less important in determining an individual's estate plan.

Taxing direct transfers also provides a logical consistency in the proposed GST tax which is lacking in the present system. In general, the proposal assures that a family's accumulated wealth will be taxed once per generation. This consistency makes the system fairer since it assures that families of comparable wealth will have comparable transfer tax burdens, regardless of how their assets are transferred from generation to generation.

An exception to the once-per-generation rule is provided, however, in the case of a transfer which skips more than one generation simultaneously (e.g., a transfer from a taxpayer to his great-grandchild). In such a case, only one GST tax is imposed even though transfer tax in two or more generations is avoided. Also, if property is transferred to a trust, the corpus of that trust cannot be subjected to the GST tax on more than one occasion. This exception will avoid the computational complexity and possibly harsh results which could come from two or more concurrent applications of the GST tax. See Examples 5 and 9 in Section 10 below.

2. \$1,000,000 Specific Exemption

Under the proposal, every individual would be entitled to make cumulative transfers, during his lifetime or at death, of up to \$1,000,000 without incurring any GST tax. This specific exemption would be similar, although not identical, in operation to the \$10,000 specific exemption for gift tax purposes that was available prior to 1977. In particular, a transferor who has not previously used his entire exemption will have the option of using all or any portion of the remaining exemption on a given transfer.

One difference from the pre-1977 gift tax specific exemption, however, would be that a transferor would be free to use his spouse's \$1,000,000 exemption against the entire amount transferred, provided the spouse consents, even if the transferor had already used up his own exemption. Moreover, a surviving spouse would be able to apply the unused portion of his or her exemption to any property included in his or her estate (e.g., qualified terminable interest property or property over which he or she holds a general power of appointment).

A grantor of a trust could elect at the time of the transfer of property to the trust or at any time thereafter whether to apply any or all of his exemption to the trust property, even if no GST tax would be payable at that time. The amount of the exemption used would be based on the value of the

property at the time of the election, regardless of its value when distributed from the trust. If all property contributed to a trust were covered by an exemption, all distributions from the trust, both during the trust term and upon its termination, would be free from the GST tax. See Example 10 in Section 10 below.

If none of the property contributed to a trust were exempted, all distributions from the trust to a beneficiary in a generation two or more levels below that of the grantor would be subject to a GST tax at the rate described in section 4 below. If a grantor transferred property to a trust whose value exceeded the amount of exemption allocated to the property, the trust would be partially exempt, and each and every generation-skipping distribution from the trust would be partially exempt from tax. The fraction of each distribution exempt from tax would be equal to the ratio of exempt property to total trust corpus, measured at the time of election of the exemption. Additions to a trust subsequent to its creation would require a recomputation of the exemption ratio, based on values at the time of the later contribution. It is anticipated that, for simplicity of administration, many grantors will arrange their affairs so as to have one or more wholly exempt trusts and one or more wholly taxable trusts.

Any portion of the specific exemption not used by a decedent during his lifetime would have to be allocated by the executor on the decedent's estate tax return. Applicable local law should permit the decedent to direct the allocation by will in most cases. If a decedent does not make a specific allocation, however, the executor would then have discretion to allocate the exemption, subject to applicable local law restrictions on the exercise of fiduciary duties. The executor could allocate the unused exemption to property included in the decedent's estate as well as to trusts created by the decedent during his lifetime. Of course, if the value of the decedent's gross estate plus any adjusted taxable gifts made by the decedent is less than the unused exemption, all transfers made and trusts created by the decedent will be exempt from the generation-skipping transfer tax.

2. Elimination of \$250,000 Exclusion for Transfers to Grandchildren

It is unclear why transfers to grandchildren should receive more favorable treatment than transfers to other members of that generation (for example, grandnieces and grandnephews). Moreover, in light of the liberal general exemption accorded each

transferor, the exclusion for transfers to grandchildren of the grantor will not be needed to avoid the imposition of GST tax on moderately wealthy families. Accordingly, the proposal would eliminate the special \$250,000 per deemed transferor exclusion for transfers to grandchildren. Repeal of this exclusion will eliminate the need for keeping records concerning the use of the \$250,000 exclusion for transfers attributed to a deemed transferor.

4. Computation of Tax

The tax rate applicable to taxable generation-skipping transfers is equal to 80 percent of the maximum estate tax rate in effect at the time of the taxable event. The maximum estate tax rate is 60 percent for decedents dying in 1983, 55 percent in 1984, and 50 percent in 1985 and thereafter. Accordingly, the GST tax rate will be 48 percent for generation-skipping transfers in 1983, 44 percent in 1984, and 40 percent in 1985 and thereafter.

The GST tax base for a generation-skipping transfer does not include the amount of any estate or gift tax payable with respect to such transfer. On the other hand, in the case of a direct generation-skipping transfer during the transferor's lifetime, the GST tax imposed on the transfer will be treated as an additional gift subject to the gift tax, even though the transferor is primarily liable for payment of the GST tax.

In the case of a taxable direct generation-skipping transfer (e.g., an outright transfer to a grandchild or a transfer to a trust which benefits only the grantor's grandchildren and lower generations), whether by gift or bequest, the GST base includes only the net amount received by the beneficiary. This parallels the tax treatment which would apply if the transfer had been made instead to a member of the skipped generation who then immediately used the property (net of transfer tax) to make a gift to the ultimate recipient and to pay the gift tax thereon. See Examples 3, 6, 7, 9 and 11 in Section 10 below. In all other cases, the GST tax base is equal to the full amount transferred, including the GST tax itself (but excluding any estate or gift tax imposed with respect to the transfer). This accords with the estate tax treatment which would obtain if the transfer had been made instead to a member of the skipped generation who then left the property at death to the ultimate transferee. See Examples 4, 5 and 8 in Section 10 below.

5. Liability for the Tax

Liability for the GST tax would follow the same pattern as the determination of the tax base described above. Thus, in cases where the GST tax is payable immediately upon the initial transfer, the transferor or his executor would be primarily liable for the tax. In all other cases, the transfer would come from a trust and the trustee would be primarily liable for payment of the GST tax.

For any transfer subject to the GST tax, the transferor, executor or trustee would pay the GST tax and distribute only the net amount to the distributee. If the tax were not paid as required, the distributee would be secondarily liable for payment of the GST tax, and any unpaid GST tax would be a lien on the property transferred.

6. Income Distributions

The present Chapter 13 excludes from the term "taxable distribution" any distribution out of the current income of a generation-skipping trust. The exclusion may be defended under present Chapter 13 because of the difficulty of computing the GST tax on income distributions each year. Under the proposal, however, income distributions to lower generations not covered by the \$1,000,000 exemption will be subject to GST tax at a flat rate which is easily computed.

Allowing an exemption for income distributions would leave far too great a potential for tax avoidance in multigenerational trusts. For example, if an individual were to fund a discretionary trust for the benefit of his children and grandchildren with income-producing property, the trustee could distribute the income of the trust to the grandchildren each year free from the GST tax and the GST tax on the corpus could be deferred until the death of the last child. This would allow the family to "freeze" the value of the trust property for GST tax purposes at its initial value (since the trust could be invested in debt securities or other assets producing high income rather than capital appreciation) and to defer the payment of GST tax without any offsetting cost. In other words, exempting income distributions would be equivalent to an interest-free loan by the government in the amount of the deferred GST tax.

In view of these considerations, the proposal would eliminate the GST tax exclusion for income distributions. Instead, any GST tax on the distribution, whether paid by the trustee or by the distributee, would be deductible by the distributee for income tax purposes. (If the GST tax is paid by

the trustee, the distributee's gross income would include the amount of the GST tax paid.) This deduction would avoid the same amount being subject to both income tax and the GST tax.

7. Limitation on Credit for Tax on Prior Transfers

Section 2013 of the Code provides a credit against the estate tax with respect to property which was subject to estate tax in the 10 years preceding (or the 2 years following) the decedent's death. While this may be a well-founded relief provision in some cases, in others it would allow a GST tax windfall. To prevent this, the proposal generally would deny the section 2013 credit in the event the ultimate recipient of the property is two or more generations below the original transferor. However, a special exception would permit the executor of the second decedent to elect to claim the credit if he also consented to have the two transfers of the property treated together as a single generation-skipping transfer from the first decedent. With this election, the aggregate tax on the two transfers will never exceed the GST tax which would have been imposed if the first decedent had transferred the property directly to the ultimate recipient.

8. Ascertainment of Generation

The present Chapter 13 contains a reasonable and workable set of rules for determining generation assignments. With certain minor amendments, the proposal will retain these rules and incorporate them into the new Chapter 13. The word "grantor," however, would be replaced throughout by "transferor" to reflect the revised focus of the tax.

9. Effective Date

In general, the GST tax imposed under this proposal would apply to all transfers from irrevocable trusts created on or after the date of enactment of the proposal, and to all direct generation-skipping transfers made on or after that date. The proposal would not apply, however, to generation-skipping transfers (either outright or in trust) under wills or revocable trusts of decedents dying before the date which is one year from the date of enactment. The effective date would be extended for testators who are incompetent on the date of enactment. This one-year transition rule will give estate planners time to understand the new rules and to adjust their planning accordingly.

The existing tax on generation-skipping transfers would be repealed retroactively, so that no trust will ever be subject to the provisions of that tax.

10. Examples

The following facts are common to Examples 1-5: T dies in 1984 and leaves his assets to two trusts. The first trust gives the trustee discretion to allocate income and corpus among T's living descendants. T's living descendants are his children, A1 and A2, and his grandchildren B1, B2 (children of A1) and B3 (child of A2). At the later of the death of the survivor of T's children (A1 and A2) or when the youngest of T's grandchildren (B1, B2 and B3) reaches the age of thirty-five, the remaining trust property is to be divided among T's descendants then living, per stirpes.

The second trust is a QTIP trust (i.e., a trust whose property T's executor elects to treat as qualified terminable interest property qualifying for the estate tax marital deduction under section 2056(b)(7)) with income to T's spouse S for life with the remainder outright to A1 and A2 in equal shares. If A1 or A2 should predecease S, his share passes to his issue per stirpes.

T and S have not elected to use any of their \$1,000,000 GST tax exemptions on lifetime transfers.

Example 1. T's gross estate is less than \$1,000,000. Both trusts are totally exempt from the generation-skipping transfer tax.

Example 2. T's gross estate is \$6,000,000. T's will funds the first trust with \$1,000,000 and leaves the residuary estate to the QTIP trust. T's executor allocates his \$1,000,000 exemption to the first trust. All transfers from this trust are then exempt from the GST tax. If A1 and A2 survive S, no GST tax will be payable with respect to the second trust at S's death.

Example 3. The facts are the same as in Example 2 except that A2 predeceases S. At S's death in 1987, the corpus of the second trust has a value of \$8,000,000. Assume that death taxes at S's death payable from the QTIP trust are \$1,600,000 so that \$3,400,000 remains for distribution to A1 and B3 in equal shares.

Assume that S allocates her entire \$1,000,000 GST tax exemption to the \$1,700,000 distribution to B3. Thus, \$700,000 of the distribution to B3 would be subject to GST tax at a rate of 40 percent. Since the GST tax on the transfer to B3 is payable immediately, the GST tax base applies only to the net taxable amount which passes to B3. To calculate the net amount transferred, simply divide the gross amount (\$700,000) by 100 percent plus the applicable tax rate (100% + 40% = 140%): $\$700,000/140\% = \$500,000$. The GST tax calculation is then

straightforward: $40\%(\$500,000) = \$200,000$. The trustee would be required to pay the \$200,000 GST tax, leaving \$1,500,000 for distribution to B3.

Example 4. T's gross estate is \$10,000,000. T's will directs that his assets be divided equally between the two trusts and that death taxes are to be paid out of the share allocated to the first trust. T applies his entire GST tax exemption to the first trust.

Death taxes are approximately \$2,500,000 so that the first trust is funded with \$2,500,000. No GST tax is payable when the trust is funded. By virtue of the \$1,000,000 exemption, any distributions of income or principal to B1, B2, or B3 are partially exempt from the GST tax. The exempt portion is 40 percent ($\$1,000,000/\$2,500,000$) so the taxable portion is 60 percent. As a result, distributions from the trust after 1984 are subject to a GST tax at an effective rate of 24 percent ($60\% \times 40\%$).

Suppose now that A1 and A2 die while the youngest of the grandchildren is still under the age of thirty-five. Even though the property continues in the first trust, at the death of the survivor of A1 and A2 there is a termination of all interests in the trust of individuals in generations above the second generation below T. Hence, all property remaining in the trust (including any accumulated income) is subject to an immediate GST tax equal to 24 percent of the value of such property. Once the tax is paid, however, all future distributions from the trust are free from further GST tax.

Example 5. Assume the same facts as in Example 4 and suppose further that B2 dies before the trust terminates, survived by a single child C (a great-grandchild of T). No additional GST tax is payable at B2's death, when the trust terminates, or when distributions are made to C.

Example 6. In 1985, T makes a gift of \$3,010,000 to his granddaughter B and pays any gift and GST taxes due on the transfer. The gift tax annual exclusion applies to \$10,000 of the gift, but T does not apply any of his GST exemption to the gift. The \$3,000,000 taxable generation-skipping transfer is subject to a GST tax at a 40 percent rate, resulting in a GST tax of \$1,200,000. T's payment of the GST tax is treated as an additional transfer subject to gift tax, making the total taxable transfer for gift tax purposes equal to \$4,200,000. If T were in the 50% bracket for gift tax purposes, the gift tax would be \$2,100,000, the total outlay by T would be \$6,310,000, and the net amount received by B would be \$3,010,000.

For comparison, suppose T had made a net gift of \$6,310,000 to B's parent A who paid T's gift tax liability of \$2,100,000 and immediately used the after-gift-tax proceeds of \$4,210,000 to make a gift to B and to pay the gift tax on the second gift. If A is also in the top (50%) gift tax bracket, the second gift tax would be \$1,400,000 and B would receive a net amount of only \$2,810,000.

This example shows that there is some transfer tax saving by using a generation-skipping transfer rather than two successive gifts to transfer the property to B. In contrast, if there were no GST tax, and if T made a net gift of \$6,310,000 to B, the gift tax would be \$2,100,000 and B would receive a net amount of \$4,210,000.

Example 7. T dies in 1985, leaving \$8,400,000 in trust for the sole benefit of his grandson B. T is in the top estate tax bracket and T's will allocates death taxes in such a way that \$4,200,000 in death taxes are payable out of the bequest to the trust for B. T does not allocate any of his \$1,000,000 exemption to this bequest. Since the generation-skipping transfer occurs at the same time as the taxable bequest, the tax applies only to the net amount which passes to the trust for B. As in Example 3, the net amount left in the trust is calculated by dividing the gross amount by 140%: $\$4,200,000 / 140\% = \$3,000,000$. The GST tax is $40\% (\$3,000,000) = \$1,200,000$.

If T had bequeathed the \$8,400,000 instead to A (B's parent), A would receive \$4,200,000 after estate tax. If A immediately had made a net gift of the \$4,200,000 to a trust for B's benefit, and if A were also in the top transfer tax bracket, the trust would receive only \$2,800,000, net of a gift tax of \$1,400,000. On the other hand, if there were no GST tax, and if T left \$8,400,000 in trust for B, the trust would receive \$4,200,000.

Example 8. T establishes a discretionary trust for the benefit of his daughter A and his grandson B and funds it with \$5,000,000, paying any estate or gift tax due upon the transfer out of other funds. T does not allocate any of his \$1,000,000 exemption to the trust. Assume that all income of the trust is distributed currently and that the value of the trust principal does not change.

Any distributions to B are subject to GST tax at a rate equal to 80 percent of the top estate tax rate in effect at the time of the distribution. This is so regardless of whether the amount distributed is less than, equals, or exceeds the annual gift tax exclusion under section 2503(b). If A dies after T but before B in 1985, the \$5,000,000 trust corpus is subject to a GST tax of \$2,000,000 (40% of \$5,000,000), leaving \$3,000,000 remaining in trust for B.

Had T made a bequest or gift of \$5,000,000 (after transfer tax) to A, and had A bequeathed the property to B in trust at her death subject to estate tax at the top rate, B would receive only \$2,500,000. Without any GST tax, B could receive the full \$5,000,000 placed in trust by T, free of any further transfer tax.

Comment. Examples 6, 7, and 8 show that the proposed GST tax will significantly reduce the benefits of generation-skipping transfers, whether during lifetime or at death, for transferors in the highest brackets. In no case, however, does the proposal impose a GST tax higher than the transfer tax which would have been paid in the skipped generation had the property passed through that generation.

Example 9. In 1985, T makes a gift of \$1,400,000 (before GST tax) in trust for the sole benefit of his great-grandchild C and pays the gift tax thereon out of other funds. T does not apply any of his GST exemption to the transfer. Even though the transfer skips two generations simultaneously, it is subject to only a single GST tax at a rate of 40 percent. Since this is a direct generation-skipping transfer, the GST tax base does not include the tax. Therefore, the balance left in the trust for C is $\$1,400,000/140\% = \$1,000,000$ and the GST tax is $40\%(\$1,000,000) = \$400,000$.

Example 10. T has two children, A1 and A2. A1 has a son B1 and A2 has a daughter B2. T establishes two discretionary inter vivos trusts, one for the benefit of A1 and A1's descendants, the other for the benefit of A2 and A2's descendants. Each trust is funded with \$250,000. T does not allocate any of her GST tax exemption to the trusts at the time they are created.

A1 dies at a time when the trust for her and her descendants has grown to \$280,000. T may then decide to allocate \$280,000 of her exemption to the trust so that future distributions to B1 will be exempt from the GST tax. If, however, any prior distributions have been made to B1, a GST tax remains payable on such distributions and any tax which has already been paid is not refundable.

Example 11. T dies in 1985, leaving \$3,500,000 after estate tax to his daughter A. None of T's \$1,000,000 exemption is allocated to this bequest. A makes a qualified disclaimer of the bequest and, as a result, the bequest passes to A's son B. Since the bequest is treated as having passed directly from T to his grandson B, the net amount transferred to B is $\$3,500,000/140\% = \$2,500,000$ and the GST tax is $40\%(\$2,500,000) = \$1,000,000$.

Part II. Comparison of Treasury and Reporters' Proposals

The Treasury Proposal has been modified since its original publication. The following comparison is based on the most recent Treasury draft statute dated February 2, 1984.¹

1. Exemption v. Credit. The issue is how smaller estates are eliminated from the generation-skipping tax. Under the Treasury Proposal, a \$1,000,000 specific exemption per taxpayer (plus an additional \$1,000,000 from each spouse of the taxpayer to the extent the spouse has not made use of it) applies on an elective basis to generation-skipping transfers made by any individual or a generation-skipping trust created by such individual. In contrast, the Reporters rely on a tax credit to limit the scope of the system. No tax is imposed until aggregate generation-skipping transfers attributable to a particular grantor exceed \$834,000.

The Treasury decision to use an exemption rather than a credit was apparently prompted by at least the following considerations:

a. A trust containing only exempt property would never have to keep any records relating to the tax.

b. At a \$1,000,000 level (or \$2,000,000 or more depending upon the number of spousal aggregations involved) most taxpayers could ignore the tax for estate planning;

1. The Treasury drafts of the statutory language to implement its proposals may be found at Paragraphs 12,045, 12,064 and 12,074 of the CCH Federal Estate and Gift Tax Reporter.

c. Lawyers, among the most vociferous opponents of Chapter 13, would lose one of their major arguments--the one based on the inability of most practitioners to cope with the law.

d. Treasury would be relieved of the burden of monitoring, and providing the information necessary for the administration of, the tax in the vast majority of trusts.

The effect of the exemption is to remove from the reach of the tax, subject only to the limitations imposed by the applicable rule against perpetuities, not only the \$1,000,000 exempt amount but also any appreciation that occurs after the exemption is claimed with respect to the transferred property. Thus, to achieve simplicity, the Treasury proposal abandons the notion of periodic imposition of tax with respect not only to the exempt amount but also its growth. While a tax credit means that no trust has absolute assurance that the tax will never apply to it, it is also clear as an empirical matter that many trusts will never be affected by the tax.

The simplification gains achieved by the Treasury approach carry significant price tags, among which are:

a. The tax is likely to be ignored by most lawyers, so its applicability and intricacies may not be recognized in many cases.

b. There will be a significant psychological push to use trusts to take advantage of any available exemption (the frequency of "grandchild exclusion" trusts in post-1976 wills

indicates that individuals will create trusts to take advantage of "benefits," even though, in pre-generation-skipping tax days, they did not take advantage of unlimited generation-skipping opportunities).

c. There will be a great temptation to undervalue assets passing to generation-skipping trusts in order to keep them within the exemption. Although this temptation is present in any gift or estate tax situation, it is extended under the Treasury proposal to transfers for value--sales--and transfers of investment opportunities to protected trusts.

d. The Internal Revenue Service will have little opportunity to audit the values assigned to assets transferred to protected trusts since, by definition, the assets will not again be subject to the transfer tax system until after the trust terminates, the property passes to an individual, and that individual makes a gift or dies.

2. Tax Inclusive (Estate Tax) v. Tax Exclusive (Gift Tax) Base

The Treasury proposals adopt a gift tax model (tax exclusive) in the case of outright skips. Presumably, this decision is based on the notion that, if the taxpayer was willing to by-pass a generation, it must be because that generation had sufficient assets already and, had it received the property, would have turned around and passed it on during lifetime (i.e., at gift tax rates). On the other hand, if the property passes through a generation-skipping trust, the tax is predicated on the estate tax model (tax

inclusive), even if the transfer out of the trust takes place while the "skipped" member of the older generation is still alive.

The Reporters proposals adopt a gift tax model in all cases except a Taxable Termination, an event that will not, in the Reporters' judgment, occur often. Moreover, even when a Taxable Termination occurs the Reporters' recommendations are flexible enough to permit distributions to be made on a tax exclusive basis.

The basis for the Treasury's decision is unclear. Perhaps it is as simple as hostility to the tax exclusive approach of the gift tax. Perhaps it is a notion--probably unfounded--that a tax inclusive system is easier for a trustee to administer (in the case of a taxable distribution, the trustee need only transfer the property and leave all valuation issues to the transferee). Or perhaps it is predicated on the idea that, in order to make an immediate on outright skips more palatable, the deferred tax on transfers out of trusts must be at higher rates.

Whatever the basis, the "transaction cost" is high. A rate differential that depends on whether the skip is direct or through a generation-skipping trust necessarily requires that financial decisions be made at fairly early stages of the planning or administration processes. For example:

a. Although it is probably demonstrable that it is economically more desirable to pay a transfer tax at a lower rate today than at a higher rate in the future (no matter how

far in the future or how much the deferred tax dollars earn or grow), few if any lawyers or clients will be able to both comprehend and accept the arithmetic.

b. For those who do not accept the desirability of early payment at a low rate, natural inclinations to pass property beyond the next lower generation will be put aside and attempts will be made to defer the tax as long as possible (probably through the creation of trusts with beneficiaries chosen primarily for their generation assignment), with all the attendant drafting and administrative complexities;

c. For those who accept the arithmetic but, for whatever reason, want to use a trust as the transfer vehicle, drafting and planning complexities will be generated by the need to insure that no beneficiary in the intermediate generation will have an interest. In other words, tax consequences will hinge on whether a trust is "pure."

3. Form of Trust. Under the Treasury proposal, the nature and timing of the tax turns on the form of the trust and the identity and generation assignment of its beneficiaries. Under the Reporters' recommendations only the identity and generation assignment of the recipient are relevant.

Some of the more serious planning and drafting problems created by the Treasury proposal have already been pointed out. There are also administrative problems, such as:

a. The determination of the tax consequences of any activity in the trust will require an accurate analysis of

the terms of the trust, the identification of all past and present beneficiaries, and the tracking of shifts in interests.

b. The existence of currently exercisable powers of appointment will make many necessary determinations uncertain.

c. Heavy burdens will be placed on nominal beneficiary rules.

4. Other Differences

The Treasury exemption is elective. An election once made is irrevocable. This aspect of the Treasury proposal introduces planning costs and uncertainties. The credit recommended by the Reporters is absorbed automatically while the grantor is live and is freely transferable after the grantor's death. Free transferability alleviates the harsh results that can occur if an irrevocable election turns out to have been made improvidently.

The Treasury proposal subjects generation-skipping transfers to tax at a flat rate equal to 80 percent of the maximum marginal transfer tax rate. This rate is necessarily arbitrary because, under the Treasury proposal, there is no real taxpayer whose rate profile can be used. The Reporters' recommendations subject skipping transfers to tax at the highest marginal transfer tax rate once the generation skipping tax credit is exhausted. This rate is not arbitrary because it relates to transfers actually made by transfer tax taxpayer.

The Treasury proposal would limit the availability of the previously taxed property credit where the ultimate recipient of transferred property is two or more generations below the original transferor. The Reporters' recommendations contemplate an expansion of that credit to limit multiple impositions of transfer tax in cases involving transfer of property to individuals in the same or higher generations.

The Treasury proposals do not amend the existing power of appointment sections. The Reporters, in a major simplifying move, recommend their repeal.

Finally, the Reporters recommend the creation of a category of trusts treated as owned by a beneficiary. The Treasury proposals do not contain a similar recommendation.

Mr. RUSSO. Thank you very much, Mr. Gutman. It is a very comprehensive statement and certainly, as somebody who has had a problem with generation-skipping since it has been enacted, I found both your statement and Mr. Pearlman's both very interesting. I would hope you and Mr. Pearlman could have done it 6 or 7 years ago.

Mr. GUTMAN. Nobody asked us.

Mr. RUSSO. That is probably the problem.

Mr. Duncan.

Mr. DUNCAN. I have no questions, Mr. Chairman. I do want to thank Mr. Gutman. He is always most helpful to the committee, and we always look forward to your being here.

Mr. GUTMAN. Thank you, Mr. Duncan.

Mr. RUSSO. Mr. Anthony.

Mr. ANTHONY. No questions.

Mr. RUSSO. Let me just ask you one question. When we look at the exemption versus the credit, in order to make the credit work well, you have to do a lot of paperwork and a lot of checking down the line as opposed to the exemption.

Mr. GUTMAN. Certainly.

Mr. RUSSO. In your statement, you made the comment that both bills do one thing, and that is make it administratively easier.

Mr. GUTMAN. Yes.

Mr. RUSSO. I would expect the exemption makes it much easier.

Mr. GUTMAN. No question about it. The exemption makes it a lot easier, but that comes at a cost. The cost is the post-transfer appreciation in the property, no matter what dollar level you pick. I am not talking about what dollar level. That is your decision to make.

I also suggest that you get a different form of administrative complexity because I don't think you would want to enact an exemption without any system for the Internal Revenue Service to monitor whether it is properly claimed. So what you may trade is taxpayers not having to worry about record-keeping for administrative costs in terms of the Service trying to assure that the exemption was properly claimed.

Mr. RUSSO. Is there any particular magic about \$417,000?

Mr. GUTMAN. No.

Mr. RUSSO. I think it amounts to something like—

Mr. GUTMAN. \$834,000 on a tax exclusive basis.

Mr. RUSSO. But the difference between the exemption and the credit is there is more recordkeeping required under the credit.

Mr. GUTMAN. Yes, there is. Somebody has to know how much credit is left. I suggest to you that that is not a hideous problem. But you are right; somebody has to keep track of the records.

Mr. RUSSO. I also suspect that it could raise more money because if you put \$1 million in the trust initially and gave it outright and over a period of years, it appreciates to \$15 million.

Mr. GUTMAN. No question about that.

Mr. RUSSO. Under the credit, there would be a significant tax paid.

Mr. GUTMAN. I think that is right. There will be more revenue raised under a credit mechanism at these dollar levels. You could adjust the exemption level to reduce the exempted class of taxpayers as well.

Mr. RUSSO. Thank you very much.

Mr. GUTMAN. Thank you.

Mr. RUSSO. I compliment you on your work, Mr. Gutman.

Mr. GUTMAN. Thank you.

Mr. RUSSO. The next group of witnesses is a panel from the American Bankers Association, the American Bar Association, and the American College of Probate Counsel and American Institute of Certified Public Accountants. We got everybody covered there.

I would like to remind the panel that we have your statements, and we will insert them in the record. I would appreciate it if each panel member would summarize their remarks in 5 minutes.

STATEMENT OF MARSHALL L. ZISSMAN, SENIOR TRUST COUNSEL, FIRST NATIONAL BANK OF CHICAGO, ON BEHALF OF AMERICAN BANKERS ASSOCIATION

Mr. ZISSMAN. Thank you.

Good morning. I am Marshall Zissman, senior trust counsel of the First National Bank of Chicago. I bring greetings from a city exalting in the hope that this will be the year that it becomes the baseball capital of the world. If we can begin the fix-up of generation-skipping today, it would really be a vintage year.

I appear here—

Mr. RUSSO. Do you think we can get our contracts straightened out? It would be a great year then.

Mr. ZISSMAN. I appear on behalf of the American Bankers Association. It is evident that everyone agrees that we must face up to the unacceptability of maintaining in chapter 13 a tax which is in-

capable of administration. So the issue before you is not whether to do something about the generation-skipping tax statute, but what to do about it.

The Treasury Department has acknowledged that existing chapter 13 must be repealed and has suggested a replacement approach which now forms the basis of H.R. 6260, which I will refer to as the Treasury proposal.

The American Bankers Association supports the approach taken in the Treasury proposal, and we urge its prompt enactment with one major modification that I will refer to in a moment.

The three principal structural changes embodied in the Treasury proposal are the granting of a \$1 million exemption per grantor, elimination of the deemed transferor concept and application of the tax to all generation skipping transfers, including direct skips.

In spite of the best efforts of the draftsmen of the Treasury proposal, it remains frightfully complex, and so one may ask if the Treasury proposal is 70 percent or 80 percent as complex as the existing chapter 13, how can we possibly support it?

The answer lies in the first major change embodied in the Treasury proposal, the substitution of \$1 million exemption per grantor in place of the so-called \$250,000 grandchild exclusions. This exemption will permit a trustee at the front end, when a trust is accepted, to determine whether or not it can ever be subject to a generation-skipping tax, and most trusts will not be subject to a generation-skipping tax, and to code each trust appropriately.

One of the main problems with existing chapter 13 is that it contemplates that trustees will monitor all principal transfers from all trusts to determine whether there are any generation-skipping tax consequences to a particular transfer. A generous exemption figure is the only means of insulating a great majority of trusts from the costly task of ensuring observance with chapter 13.

On the other hand, the ALI proposal set out in H.R. 6261 is based on the grant of a credit, as Mr. Gutman has explained, rather than an exemption. That credit approach would add enormously to the complexity of administering chapter 13. It would result in a system that required trustees to continue to evaluate the generation-skipping consequences of every transfer—from every trust—from its creation to termination. The credit approach would ignore the possibilities for simplification by the exemption approach. We oppose any solution based on a credit approach.

Further, we believe the \$1 million exemption figure is the minimum required to make a replacement statute attractive as a satisfactory response to the problems under current law. The trusts that would not be sheltered by that exemption—and, therefore, would be subject to tax—are the large trusts, the very trusts that are viewed as a primary target of chapter 13, and that would be fine.

Of course, a considerable chunk of the complexity of existing chapter 13 is attributable to the deemed transferor concept, a concept whose time has clearly not come. The Treasury proposal eliminates the need for the deemed transferor concept by imposing a flat rate of tax. We believe that that change represents a substantial simplification and is a step in the right direction.

The third major change envisioned by Treasury is the application of the tax to all generation-skipping transfers, including the so-called direct skips. We believe that equity demands a generation-skipping tax on these direct skips in order to achieve fairness between the superwealthy and those I will refer to as the moderately wealthy. We have lived in a generation-skipping environment over the last eight years, and we have learned some lessons.

One of the lessons is that in real life, the super-wealthy don't have to subject their assets to a generation-skipping tax unless they really want to. For example, a super-wealthy individual with an estate of \$25 million has enough property to permit him to provide for his children and also to make direct skipping transfers either in trust or outright. Direct skips can be made either way for each of his grandchildren and great-grandchildren, and none of those transfers would be subject to a generation-skipping tax under existing chapter 13. The process, of course, is called layering.

On the other hand, the person who is only moderately wealthy, say, with an estate of \$5 million or so, really doesn't have enough assets to play the game that way. So that size estate would have to be subjected to a generation-skipping tax.

We believe it is inappropriate for Congress to ignore this experience of the last eight years. If direct skips are not going to be subjected to a revised chapter 13, then the curious result will be that chapter 13 will apply only to the estates of the moderately wealthy. Families with less than \$2 million will not be subjected to the tax because of the exemption amounts. Families with more than \$10 million will be able to avoid as much of the generation-skipping tax as they choose to through the use of the layering device.

The tax would then apply only to families with between \$2 and \$10 million. We really don't think that that kind of a tax can be justified. Taken as a whole, the Treasury proposal represents a reasonable approach to the generation-skipping problem. Assuming that it is accompanied by a relatively current effective date rule, the American Bankers Association supports it, but for reasons of simplification, we also urge a complete exclusion of current income from the tax.

Existing chapter 13 exempts current income from tax. That exemption was inserted primarily for administrative convenience and for simplicity. It prevented imposition of two taxes, an income tax and generation-skipping tax on the same dollars.

To subject distributions of ordinary income to a generation-skipping tax would add considerable complexity to a system that we are all trying to simplify. To most members of our industry, income distributions are automated. They are administered by a clerical staff with a systems orientation. To try to install a judgmental capability at that level, which would permit the distinction to rise between those distributions of ordinary income which are to be subject to chapter 13 and those which are not to be subject to chapter 13 would either be very expensive or very time consuming or impossible, or all of the above.

In addition, we really don't believe that this suggested simplification has a very high price tag in terms of lost revenue.

Let me take just a moment to share with you our reaction to the specific issues that you asked us to comment on. The first issue has

to do with how a generation skipping tax should apply to trusts administered for more than one younger generation.

We agree an argument can be made that an ideal generation-skipping system would apply a tax to each younger generation. Existing chapter 13 was designed to accomplish that very result. But the attempt led to such complexity that everybody now agrees we have to scrap it. We need a generation-skipping system that will impact a limited number of trusts, that will impose a tax on the happening of an event and then remove the trust from the system rather than a system that requires a manual monitoring of a lot of transfers, a lot of trusts, with some trusts moving out of the system and subsequently reentering the system at a future date.

As to the credit versus the exemption area, we don't believe this is a close question. The exemption represents the only acceptable alternative.

As to the issue involving the transferability of the unused exemption, we don't think that the trafficking argument is really worth worrying about. If property can pass between spouses free of tax through a 100 percent marital deduction, it seems strange to worry about the transfer of an exemption. We would opt for transferability.

The fourth issue raised by staff has to do with the \$10,000 exemption amount. Since we favor a complete income exemption, naturally as a fallback, we would certainly support the lesser \$10,000 exemption.

The final issue has to do with the credit for State generation skipping taxes. We favor the inclusion of this kind of a credit because we think it will encourage States to piggyback on the Federal law when they adopt their own generation-skipping statutes. That means reduced complexity.

Let me close with this comment. We believe the time has come to bite the bullet on generation skipping. We have lived with an incomprehensible law for 8 years. We have lived without substantive regulations for 8 years. For 8 years, while some of the best minds in the country examined legislative alternatives, we in the trust industry have been subjected to the threat of liability if we fail to observe the requirements of a law that no one understood and everyone agreed was unworkable.

We have reached a point where certainty as to what the law is will be more attractive than the allure of a perfect statutory product which so far has eluded the grasp of everyone. The American Bankers Association is prepared to accept something less than perfection, now.

We urge you to move forward as quickly as the legislative process will permit. We recommend that you approve the Treasury proposal with the one simplification we have suggested.

Thank you.

Mr. Russo. Thank you, Mr. Zissman.

[The prepared statement follows:]

STATEMENT OF MARSHALL L. ZISSMAN, SENIOR TRUST COUNSEL, FIRST NATIONAL BANK OF CHICAGO, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

SUMMARY

Good morning.

Introduction

My name is Marshall Zissman. I am Senior Trust Counsel of the First National Bank of Chicago. I appear here this morning on behalf of the American Bankers Association.

Discussion of Treasury proposal

The Treasury Department has acknowledged that existing Chapter 13 must be repealed, and has suggested a replacement approach which now forms the basis of H.R. 6260 which I will refer to as the "Treasury Proposal." The American Bankers Association supports the approach taken in the Treasury Proposal and urges its prompt enactment, with one major modification which I will discuss later.

The three major structural changes embodied in the Treasury Proposal are: (1) The granting of a \$1 million exemption per grantor; (2) the elimination of the "deemed transferor" concept; and (3) the application of the tax to all generation-skipping transfers, including "direct skips."

\$1 million exemption

In spite of the best efforts of the draftsmen of the Treasury Proposal, it remains frightfully complex. Reference to these areas of complexity and our comments on the technical adequacy of the Treasury Proposal and of the ALI Proposal are set forth in our written submission, and we will of course be pleased to continue to provide technical assistance as Staff proceeds with its work.

Well, if the Treasury Proposal retains 70% or 80% of the complexity of existing Chapter 13, how can we possibly support it? The answer lies in the first major change embodied in the Treasury Proposal . . . the substitution of a \$1 million exemption per grantor in place of the so-called \$250,000 grandchild exclusions. This exemption will permit a trustee, at the front end, when a trust is accepted, to determine whether or not it will ever be subject to the generation-skipping tax . . . and most of them will not . . . and to code it appropriately.

One of the main problems with existing Chapter 13 is that it contemplates that trustees will monitor all principal transfers from all trusts to determine whether there are any generation-skipping tax consequences of a particular transfer. A generous exemption figure is the only means of insulating the great majority of trusts from the costly task of insuring observance of Chapter 13.

The ALI Proposal, set out in H.R. 6261, is based on the grant of a tax credit, rather than an exemption. That credit approach would add enormously to the complexity of administering Chapter 13 and would result in a system that required trustees to continue to evaluate the generation-skipping consequences of every transfer—from every trust—from its creation to its termination. The credit approach would just ignore the opportunity for simplification offered by the exemption approach. We oppose any solution based on a credit approach.

We believe the \$1 million exemption figure is the minimum required to make a replacement statute attractive as a satisfactory response to the problems under current law. The trusts not sheltered by the exemption would be the large ones, the very trusts viewed as a primary target of Chapter 13 which, because of their size, should be able to support the costs associated with an account by account, transfer by transfer, manual effort to interpret and apply the technical complex requirements of the Treasury Proposal.

Elimination of deemed transferor concept

A considerable chunk of the complexity of existing Chapter 13 is attributable to the deemed transferor concept, pursuant to which the calculation of the tax on a generation-skipping transfer is based on a determination of the marginal transfer tax rate applicable to a particular taxpayer who may, or may not, have anything to do with the transfer which is the subject of the tax.

The Treasury Proposal eliminates the need for a "deemed transferor" concept by imposing a flat rate of tax. We believe that change achieves substantial simplification and is a step in the right direction.

Taxing direct skips

The third major change envisioned by the Treasury Proposal is the application of the tax to all generation-skipping transfers, including so-called direct skips, rather

than merely to transfers involving beneficial interests shared by members of different generations. We believe equity demands a generation-skipping tax on these direct skips in order to achieve fairness between the "super wealthy" and those whom I will call the "moderately wealthy."

We've lived in a generation-skipping environment over the last eight years—and we've all learned some lessons. One of the lessons is that, in real life, the super wealthy don't have to subject their assets to a generation-skipping tax—unless they want to.

For example, a super wealthy individual with an estate of \$25 million has enough property to permit him to provide for his children and also to make direct skipping transfers, either in trust for outright, for each of his grandchildren—and for each of his great-grandchildren—and none of these transfers would be subjected to a generation-skipping tax under existing Chapter 13. This process is called "layering," because a separate transfer is made to, or for the benefit of, each generational layer of decedents.

On the other hand, a person who is only moderately wealthy really doesn't have enough assets to play the game this way.

We believe it would be inappropriate for Congress to ignore the experience of the last eight years which has taught us that "layering" has been, and would be, availed of by the super wealthy to avoid the impact of Chapter 13. If direct skip transfers are not to be subjected to a revised Chapter 13, we will wind up with the curious result of the tax applying only to the estates of the moderately wealthy. Families with less than \$2 million will not be subjected to the tax because of the exemption. Families with more than, let us say, \$10 million, will be able to avoid as much of the Chapter 13 tax as they want to by using the "layering" device. The tax would then apply only to those families with estates between \$2 and \$10 million. We don't think that result can be justified.

ALI proposal

Based on our analysis of the two discussion drafts, we have observed that, wherever the Treasury Proposal and the ALI Proposal diverge on any significant issue, we favor the approach of the Treasury Proposal. It is based on a simpler and more practical concept which makes only a limited number of trusts subject to its provisions. Further, in addition to the exemption/credit issue I have just discussed, we do not favor a system which would: (i) delay the imposition of the generation-skipping tax until the death of the grandchild's generation; or (ii) eliminate the federal estate tax on property subject to a general power of appointment.

We believe the ALI Proposal is inferior to the Treasury Proposal on technical and simplification grounds.

Recommendation for exclusion of current income

Taken as a whole, the Treasury Proposal represents a reasonable approach to the generation-skipping problem, and is a substantial improvement over existing law. Assuming that it is accompanied by a relatively current effective date rule, the American Bankers Association supports the approach taken in the Treasury Proposal, except that, for reasons of simplification, we urge a complete exclusion of current income from the tax.

Existing Chapter 13 exempts current income from tax. The exemption was inserted primarily for administrative convenience and simplicity. It prevents the imposition of two taxes—an income tax and a generation-skipping—on the same dollars. Naturally, it also makes unnecessary a deduction or credit device that would have to be designed to eliminate a double tax on an income distribution.

To subject distributors of ordinary income to a generation-skipping tax would add considerable complexity to a system we're trying to simplify.

The Treasury Proposal already contains a provision which could exempt the first \$10,000 of a trust's annual income. Furthermore, as to each trust we are talking about, our suggested extension of this income exclusion would apply for only a relatively limited period of time because, in any event, trust principal would be taxed no later than the death of the grantor's child; thereafter, trust income would not be subject to generation-skipping tax anyway. For these reasons, we do not believe that our suggested simplification has a very high price tag.

Conclusion

Let me close with this comment. We believe the time has come to bite the bullet on generation-skipping. An enormous amount of time has already been spent on debating the issue. We believe it is time to act. We urge you to move forward as quickly as the legislative process will permit. We recommend that you approve the Treasury Proposal with the one simplification we have suggested. Thank you.

Introduction

The Trust Division of the American Bankers Association (the ABA) welcomes the opportunity to submit its views on simplifying the current Chapter 13 tax on certain generation-skipping transfers. No dispute exists regarding the desirability of, or more accurately the necessity for, making substantial changes in Chapter 13, which was enacted as part of the Tax Reform Act of 1976 and has been modified to respond only to a few technical problems. In announcing this hearing the Chairman said he was "concerned with the complexity of the existing generation-skipping tax structure." His concern is shared by virtually everyone who has to deal with this tax, including our member banks. The Chairman also expressed his belief that the generation-skipping tax "improved the fundamental equity of the Federal transfer tax system." We understand the logic of imposing a tax on generation-skipping transfers in order to protect the transfer tax system. However, a tax so complex that it cannot be understood or administered is not fair. After eight years final regulations under Chapter 13 have not been issued and significant interpretive problems remain unresolved.

The Treasury discussion draft (H.R. 6260)

The Treasury Department has acknowledged the problems with Chapter 13, which it describes as having "extraordinary complexity", and would make the following three major changes:

1. The elimination of the "deemed transferor" to determine the rate of tax and the substitution of a flat rate of tax equal to eighty percent of the highest estate tax rate in effect at the time of the generation-skipping transfer; and
2. The substitution of an exemption of \$1 million per grantor, which is transferable to his or her spouse, for the current grandchild exclusion of \$250,000 per deemed transferor (a child of the grantor);
3. The application of the tax to all generation-skipping transfers rather than only to those transfers where trust benefits are split among younger generation beneficiaries assigned to two or more younger generations.

H.R. 6260 is a reasonable approach to the generation-skipping problem and is a substantial improvement over existing law. The ABA supports the Treasury solution, except that (1) for reasons of simplification and fairness which will be explained below we urge continuation of the present law's exemption of distributions of current trust income from the tax and (2) we disagree with a few technical policy decisions.

H.R. 6260 achieves simplification by (1) the use of an exemption which will create certainty at the inception of most potential generation-skipping trusts that they will not be subject to tax and means the tax may be ignored for these trusts, (2) the use of a flat rate of tax for those trusts which are not protected from tax by the exemption which eliminates record-keeping for trustees, beneficiaries and the IRS and (3) the creation of an exemption from the tax for property which continues in trust after a taxable termination takes place, thus permitting the tax to thereafter be ignored for such property. Nevertheless, much of the complexity of current law is retained and is required under a wait and see approach of only transfers which skip a generation for transfer tax purposes being subject to the tax. Because of continuing complexity, H.R. 6260 would be unacceptable to the ABA were a significant exemption figure not available.

A \$1 million exemption is the minimum figure required to make H.R. 6260 attractive as a solution to the problems of current law. The importance of an exemption of this amount in order to eliminate a large percentage of trusts from the application of the tax can be seen from estate tax returns filed during 1977 (the latest information available, which is in IRS publication 764 (12-79)). In that year 200,747 returns were filed and 139,115 were taxable returns. In general, returns were required for estates having a value of \$60,000 or more. Only 4,420 of these returns had a gross estate of \$1 million or more. 3,004 of these were in the \$1-2 million range, 681 were between \$2-3 million, 432 were between \$3-5 million, 213 were between \$5-10 million and 90 were over \$10 million. These figures do not reflect a reduction for estate taxes which must be taken into account in determining the effect of an exemption from the generation-skipping tax because the exemption applies after the estate tax has been subtracted. Recognizing these figures are somewhat outdated, the significant point is that a combined exemption for spouses of \$2 million will cause the tax to apply to only a very limited number of very large trusts. These trusts are the primary target of Chapter 13 and are, because of their size, able to support the costs

associated with the required case by case "manual" effort to apply the technical aspects of H.R. 6260 by our member banks.

Suggestions for change in H.R. 6260 have been made, which include: (1) Increasing the exemption from \$1 million to a higher figure; (2) Increasing the rate of tax to the highest transfer tax rate but determining the tax on a tax-exclusive approach based upon the value of the property received by the beneficiaries. Using a 50 percent top rate of tax, the rate of tax on a tax-exclusive basis would be 33 1/3 percent; and (3) Eliminating the tax on direct generation-skipping transfers, which is controversial and makes the scope of H.R. 6260 broader than Chapter 13.

We do not oppose suggestions 1 and 2, which would further reduce the impact of the tax. Simplicity is achieved for the transfers taken out of the system by the larger exemption because for them the tax is in effect repealed, but complexity remains for those still in the system. We oppose suggestion 3.

Tax on direct generation-skipping transfers

As mentioned above, H.R. 6260 subjects direct generation-skipping transfers—for example a cash gift transfer to a grandchild—to tax. This is controversial and is a broadening of current Chapter 13, which imposes a tax only on trust or trust-like transfers which split benefits between younger generation beneficiaries assigned to two or more generation levels. Assuming an exemption of \$1 million (\$2 million for a husband and wife), a tax on direct skips does increase the equity of the tax as between very wealthy individuals and super wealthy individuals whose transfers will remain subject to the tax. A super wealthy individual has sufficient property to bypass his children as to a part of his property. To illustrate, an individual with a taxable estate of \$20 million could, after the payment of \$10 million in estate tax, leave \$3 million to each of his two children and still leave \$4 million directly to his grandchildren. On the other hand, an individual who is only very wealthy may not feel able to do that. For example, an individual with a taxable estate of \$10 million would have about \$5 million available after the payment of the estate tax and may feel required to leave his entire estate to his children to support their accustomed manner of living. The appropriate way to address this fairness issue is to subject direct generation-skipping transfers to tax. The \$1 million exemption and the exemption for annual exclusion lifetime gifts permit significant transfers to be made in direct skips without the imposition of a tax.

Critics of taxing direct skips point out that the generation-skipping tax is regarded as a backstop for the gift and estate taxes and that these taxes do not make a distinction between transfers to children and to grandchildren in terms of the tax imposed. We understand the argument but submit fairness dictates that an escape hatch should not be left open for super wealthy individuals to make direct generation-skipping transfers to grandchildren or more remote descendants and thus avoid the tax on the property so transferred.

Other critics contend that direct skips should not be subject to generation-skipping tax because no sharing of beneficial interests in such transfers by members of different generations occurs. They correctly point out that, in 1976, Congress concluded this sharing characteristic was the critical element in determining whether Chapter 13 would apply. However, we believe Congress should not ignore the experience of the last eight years, which is that "layering" of outright or trust transfers has been used and would be used by the super wealthy to avoid Chapter 13. If such transfers are not subjected to a revised Chapter 13, we will have the curious result of the tax applying to estates of the very wealthy but only in part to estates of the super wealthy. Families with less than \$2 million will not be subjected to the tax because of the exemption. Families with more than, let us say, \$10 million, may avoid as much of the Chapter 13 tax as they want to by using the layering device. The tax would then apply only to those families with estates between \$2 and \$10 million. We do not think such a result can be justified.

The suggestion has also been made that the tax on direct generation-skipping transfers be removed from H.R. 6260 and considered at a later time. We see no reason to defer consideration of direct skips. No testimony at any future hearing will produce new information about behavior patterns of super wealthy and very wealthy individuals which should cause this Committee to change its position on the issue presented. This Committee should decide the policy question now.

We do, however, disagree, with H.R. 6260's treatment of direct generation-skipping transfers when a child of the transferor precedeases the transferor and transfers are made to that child's children. In such a case transfers to the children of the deceased child should not be subjected to a generation-skipping tax. For parity of treatment, transfers from trusts to children of a deceased child of the

transferor should be exempt from tax when the deceased child was not a beneficiary of the trust.

The income exemption

Current Chapter 13 exempts a distribution of current income from tax. This exemption was inserted primarily for administrative convenience and simplicity and has its primary significance for a discretionary trust where the trustee is authorized to distribute income and/or principal among beneficiaries assigned to the first and second generations below the transferor. It avoids imposing two taxes—an income tax and a transfer tax—on the same amount and the need for a deduction or credit to eliminate a double tax on the income distribution. The imposition of two taxes on income distributions would in our judgment not be understood by beneficiaries and result in substantial noncompliance in reporting the transfer tax, particularly when the trustee is an individual.

The first draft statute of the Treasury proposal contained no income exemption. In support of an exemption we said in effect to the Treasury:

Super wealthy estate owners would probably continue to "layer" transfers in trust to their grandchildren and more remote descendants by not creating any interests in their children as to such transfers. The \$1,000,000 exemption would be claimed against such transfers and annual exclusion gifts could also be made to the trust or trusts through the use of powers of withdrawal. Trusts would also be created for children. The administration of the layered trusts would be simple because distributions to the children from their trusts would be exempt from Chapter 13 as would distributions from the trusts for grandchildren and more remote descendants. A tax determination would occur at the deaths of the children (or their spouses) with respect to the children's trusts.

Very wealthy (but not super wealthy) estate owners whose estates will not be fully protected from the Chapter 13 tax by the \$1,000,000 will not "layer" to a significant extent because (i) they do not want to pay the gift tax that would be incurred to make full use of the \$1,000,000 exemption—the unified credit would protect at most \$600,000 from gift tax—and/or (ii) they do not want to set aside a significant part of their estates exclusively for grandchildren and more remote descendants. As a result, the use of a discretionary trust or trusts for descendants—children and grandchildren will continue to be a common dispositive pattern.

Under the prior draft statute, distributions of income or principal from a discretionary trust for descendants to grandchildren will be a taxable distribution. This result cannot be avoided unless the exemption is claimed as to the entire principal of the trust, which the grantor may be reluctant to do because substantial distributions of principal may be made to children. Also, to the extent the distribution is treated as income for income tax purposes an income tax will also be paid with a deduction being allowed in computing the income tax for the Chapter 13 tax on the income. This complexity will not be understood by many beneficiaries.

In short, the failure to provide an income exclusion presents a fairness problem between super wealthy and very wealthy transferors similar to the one involved in the direct skip case discussed above.

Responding to our position, the Treasury's last draft statute (No. 3) contained a simple exemption for a distribution of \$10,000 per year to an individual assigned to a generation two or more generations below the transferor provided certain conditions were met, but the Treasury was unwilling to go further. This exemption is contained in modified form in a lengthy and complicated proposed section 2625 with special rules the second of which should be changed in proposed subsection (d)(2) to substitute the words "is less than" for "exceeds". We disagree with the policy changes made from the prior Treasury draft in treating a husband and wife as one individual for purposes of the exemption and in reducing the amount of the exemption by the amount of nonqualified distributions in subsection (d)(1).

More important, the \$10,000 figure will not be sufficient in a few years to cover the college expenses (excluding tuition) of a grandchild or a car for a grandchild. To a considerable extent the Treasury's objections to a full income exemption are based upon protecting the integrity of the tax on a direct skip to such a person. It asks if a direct skip is taxed why shouldn't a transfer of trusty income be taxed? While we understand Treasury's concern we believe (1) the simplicity achieved by not having an income distribution subject to both an income tax and a transfer tax is important and (2) fairness is achieved as between super wealthy and very wealthy transferors by not establishing a system that permits only the former to avoid the complexity of the double tax problem by layering. Further, the trust principal will be taxed no later than the death of the last to die of the beneficiaries to whom the trustee may distribute income or principal assigned to the first generation below the

transferor; thereafter trust income would not in any event be subject to the generation-skipping tax. Also, the creation of a separate trust or trusts for grandchildren and using the exemption against these trusts is not a satisfactory alternative. A very wealthy but not super wealthy transferor often will not desire the create separate trusts for them because the primary beneficiaries are intended to be the children and a discretionary trust for children and grandchildren will be created.

Continuing complexity

As previously mentioned, H.R. 6260 does simplify current law. However, much of the complexity of current Chapter 13 is retained and is required by a wait and see approach which taxes only actual skips. We would like to mention some specific points causing the complexity (in addition to the \$10,000 exception discussed above) with the hope that some of them can be addressed in the legislative process.

1. Definition of "interest". This term is key to the operation of H.R. 6260 because the definitions of "direct generation-skipping transfer" and "taxable termination" use the term. The definition of "interest" differs from the definition of this term in IRC Sec. 2613(d)(1) because future interests are ignored. A person is deemed to have an "interest" if "at the time the determination is made" he or she is "a permissible recipient" of income or corpus. We are uncertain how these words will be interpreted when the purposes for which distribution may be made are limited. To illustrate, let us assume payments may be made for the support of A. Will A have an interest? Will the answer depend upon whether the trustee must take account of A's other sources of funds? If A is deemed to have an interest, what is the extent of the interest? Stated another way, does his interest extend to entire trust or does the interest extend to only a part of the corpus and if so how is that part determined?

A person is deemed to have an "interest" if he or she "has a right (other than a future right) to receive income or corpus." If A has a right to withdraw five percent of corpus each calendar year if he is living on the last day of such year is this a "future right." If the right is a present right, does the right extend to the entire corpus?

2. Nominal interests. Proposed section 2652(c)(2) provides that "an interest which is used primarily to postpone or avoid the tax imposed by this chapter shall be disregarded." This language would be interpreted in the regulations but considerable difficulty would be encountered in doing so and dealing with a subjective intent issue. The prior Treasury draft statute (No. 3) was more helpful. We suggest that the statute create a safe haven for a discretionary interest of an individual who is a lineal descendant of the transferor or a spouse of the transferor or of a lineal descendant of the transferor and state that a discretionary interest in charity will be treated as a nominal interest.

3. Large number of defined terms. H.R. 6260 follows the approach of current Chapter 13 of having a large number of defined terms which are interrelated. In fact, the number of defined terms is increased. A list of these terms is as follows: (1) Generation-skipping transfer; (2) Taxable distribution; (3) Taxable termination; (4) Direct skip; (5) Non-trust direct skip; (6) Trust direct skip; (7) Skip person; (8) Non-skip person; (9) Taxable amount; (10) Qualified distribution; (11) Applicable rate; (12) Inclusion ratio; (13) Applicable fraction; (14) Nontaxable gift; (15) Nontax portion; (16) Transferor; (17) Trust; (18) Trustee; (19) Interest; and (20) Transferee. We believe that like current Chapter 13 the technical and complex operation of H.R. 6260 (or H.R. 6261) will not be understood by most persons who will have to deal with it. Every reasonable effort must be made to simplify statutory language.

The ALI proposal (H.R. 6261)

The American Law Institute Study on Generation-skipping Transfers under the Federal Estate Tax concluded that such transfers should be subject to tax and uses a different approach. H.R. 6261 represents the views of a limited number of individuals and has not been approved by the Institute. For the reasons discussed below, we doubt that it will be approved by the Institute and believe H.R. 6260 is a better approach. H.R. 6261 differs in several significant respects from H.R. 6260, the most important of which to the ABA is the use of a credit rather than an exemption. Assuming that the amount covered by a credit or exemption is the same, the major distinction between them is that changes in value of affected property are significant with a credit but are irrelevant when an exemption is used. We understand the logic of using a credit, which would accord with the policy of current Chapter 13 and with the approach of the gift and estate tax.

However, an exemption provides much greater administrative simplicity than a credit because of the certainty that the tax will not apply to the property as to which the exemption has been used. An exemption makes it possible to say that a trust is or is not subject to the tax. A credit renders this uncertain until a taxable

event (or perhaps several such events) have occurred. An exemption responds in a much more satisfactory way to the criticism of current Chapter 13 that all potential generation-skipping transfers are subject to the tax and that records must be kept by the IRS and taxpayers on all such transfers. An approach which uses a credit rather than an exemption continues a burdensome administrative complexity in current Chapter 13 which is unacceptable to our member banks irrespective of the level of the credit.

The ABA disagrees with other aspects of H.R. 6261. The significant areas of disagreement are:

(1) A transfer to a trust for grandchildren or more remote descendants is not subject to tax as a direct skip, which occurs under H.R. 6260. The postponement of transfer tax possibilities are substantial, particularly with super wealthy individuals who may make layering transfers for grandchildren and great-grandchildren.

(2) The failure to impose a tax on trust transfers at the death of children of the transferor who have interests in the trust, as does H.R. 6260, represents a partial and significant repeal of the estate tax and creates an incentive to establish trusts for children rather than making outright distributions to them. The most extreme illustration of policy decision is an owned trust that elects to be treated as a non-owned trust. This election combined with the proposed repeal of IRC Sec. 2041, relating to general powers of appointment, creates a loophole of substantial scope. If a father creates a trust for his daughter and gives her an unrestricted power to withdraw principal, the trust is an owned trust. An election to treat a trust as a non-owned trust would mean that the trust property is not included in the daughter's estate for estate tax purposes and under H.S. 6261 no generation-skipping transfer occurs at the daughter's death, assuming the property stays in trust for the daughter's children. Of course, this result would not occur if IRC Sect. 2041 is retained. The creation of a distinction for estate tax purposes between property owned outright by a child and property held in trust subject to an unrestricted power of withdrawal by another child is a bad policy decision in the context of H.R. 6261's failure to treat the termination of the child's trust interest as a taxable termination.

(3) The tax on a taxable distribution is imposed on the trustee rather than on the distributee, as occurs under current law and under H.R. 6260. We oppose changing current law and having the trustee on an outright distribution file the return and pay the tax, if any.

(4) The tax could be imposed more than once on long term trusts, which cannot occur under H.R. 6260. This result, combined with the use of a credit rather than an exemption, produces significant complexity and administrative and record keeping difficulties for trustees and the IRS.

Effective date rule

Effective date provisions were omitted from H.R. 6260 and H.R. 6261. These provisions in the last Treasury draft statute provided a "grandfather" for (1) irrevocable draft trusts in existence on the date of enactment, except to the extent of additions after that date, (2) trusts consisting of property included in the gross estate of a decedent dying within the first year after the date of an enactment and (3) direct generation-skipping transfers occurring as a result of the death of a decedent within such one year period. We recognize the concerns regarding irrevocable inter vivos trusts that are hereafter created in anticipation of the repeal of Chapter 13 and the substitution of a new law and suggest that the Treasury approach could be modified to provide that the new law would apply to inter vivos trusts created after a future date which precedes the date of enactment.

Specific issues on which comment requested

Comments have been requested on five issues. We have discussed above in detail our preference for an exemption over a credit. Our comments on the remaining four issues are as follows:

A. Trusts providing for multiple skips

For long term trusts neither H.R. 6260 nor H.R. 6261 provide for a tax every generation. We recognize the logic of imposing a tax at the termination of the interests of each younger generation, as does current Chapter 13 leaving aside the grandchild exclusion. However, such an approach would require additional complexity and record keeping for trusts and the IRS. If H.R. 6260 or H.R. 6261 were modified to achieve this result we believe they would be criticized as being unacceptably complex. Some will say they are already unacceptably complex without such a change. We stress again that a primary advantage of the exemption in H.R. 6260 is the simplicity achieved by knowing that trust property protected by it will never be subject

to the generation-skipping tax so long as the property is not transferred by an individual for gift or estate tax purposes. Thus, the tax may be ignored.

B. Transferability of unused exemption

The concerns expressed regarding the complexity and abuse potential of the transferability of any unused exemption between spouses are exaggerated and are more imaginary than real. We do not believe the "trafficking" in exemptions through short-lived marriages should be regarded as a serious concern. Furthermore, some of the restrictions suggested are unfair. One suggestion is that the exemption be restricted to transfers by the donee spouse for the transferor's lineal descendants. Such a restriction would prevent the donee's spouse from using the exemption for a single trust for her descendants and the transferor's descendants. Another suggestion is that the transferability would be limited to QTIP property. Why should the transferor be forced to create a trust when he wants to leave the property outright to his spouse? Also, what happens if the QTIP property is distributed by the trustee to the surviving spouse?

C. \$10,000 per year exemption for certain distributions

As discussed in detail above, the ABA favors a complete exemption for current income distributions. The simplicity achieved by this change in H.R. 6260 is significant when one considers proposed section 2625. Placing restrictions on such an exemption produces complexity as would the reallocation method on which comment is requested. Frequent valuations of trusts and additional recordkeeping burdens would be created which are undesirable.

D. Credit for State taxes

The Chapter 13 tax is essentially a backstop for the estate tax in the case of taxable terminations which occur as a result of the death of a trust beneficiary. Thus if a credit for state death taxes is allowed in computing the federal estate tax we believe the appropriate policy decision is to allow a credit against a federal generation-skipping tax for a state generation-skipping tax in the case under discussion. Current Chapter 13 and H.R. 6260 permit such a credit. An additional benefit to be derived from permitting credits for states taxes is conformity in the federal and state transfer taxes. In recent years a number of states have repealed their inheritance taxes and piggy-backed on the federal law. This development should be encouraged and permitting a credit against the federal generation-skipping tax for certain taxable terminations does so.

Technical comments on H.R. 6260 and 6261

We have some technical comments H.R. 6260 and 6261 which we will not discuss in this statement. We would be pleased to share our concerns with staff upon a request being made.

Mr. Russo. Our next witness will be Mr. James B. Lewis, chairman of the section on taxation.

STATEMENT OF JAMES B. LEWIS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. LEWIS. Yes, Mr. Chairman.

I am pleased to appear here on behalf of the American Bar Association with Jackson Bruce, the chairman of the section of real property, probate and trust law.

The American Bar Association has recently reexamined its attitude toward the generation-skipping tax which was formerly simply for repeal.

In August, the Association authorized Mr. Bruce and me to work with this committee, the Senate Finance Committee, and the Treasury Department in developing a reasonable alternative to the present complex statute while continuing to ask that the present complex statute be repealed.

Mr. Bruce and I are ready to discharge that responsibility. I cannot, within the time limits given me, attempt to discuss the several substantive questions on which my paper and the papers of

other witnesses present quite a diversity of views, including a diversity of views on the five specific questions on which you asked for public comment.

I note only that the existence of this wide diversity of views should, I think, cause you to consider implementing the collegial approach that worked so well recently in developing a new system for taxing installment sales and a new system for treatment of subchapter S corporations and their shareholders.

That kind of collegial approach in which the outside Bar and the staff of this committee, the other congressional tax staffs and the Treasury staff work together is the only way in which you can expect to produce a really well-drafted statute which, with all due respect, H.R. 6260 and H.R. 6261 are not, and a generally acceptable compromise proposal that will reflect policies of neutrality and consistency with the rest of the transfer tax system.

A better legislative product will be achieved by this collegial process than can possibly be expected by a last-minute resolution in conference held under the sharp time constraints common to crowded congressional calendars.

The recently enacted alimony provisions of the 1984 act illustrate how bad a product can be produced by hasty conference action.

We urge you, therefore, to ask your staff and the other governmental staffs to join with us in developing a reasonable compromise proposal.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES B. LEWIS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

SUMMARY

Mr. Chairman and Members of the Committee, my name is James B. Lewis. I am Chairman of the section of Taxation of the American Bar Association. I am pleased to appear as co-spokesman for the American Bar Association with Jackson M. Bruce, Jr., Chairman of the Section of Real Property, Probate and Law.

The American Bar Association has recently modified its position on the generation-skipping transfer tax, which formerly was simply for repeal, to authorize Mr. Bruce and me to assist this Committee, the Senate Committee on Finance, and the Treasury Department in developing a reasonable alternative to the present complex statute, while still urging that the present statute be repealed. Mr. Bruce and I are ready to discharge that responsibility.

There are important issues to be decided relating to the level and form of the exemption for smaller estates, the tax rate structure, the tax treatment of direct generation-skipping transfers in which the intermediate generation has no interest, the tax treatment of trust distributions of current income, and the frequency and timing of imposition of the tax.

There are three principal current proposals for a substitute for the present unworkable statute, one advanced by the Treasury Department, one prepared for consideration by the American Law Institute, and one prepared by a consensus of representatives of this and other bar groups. None of these proposals is inherently superior to the other two in all respects.

In the statement I am filing with your Committee, I attempt to respond to the five specific issues on which your Chairman has requested public comment.

What is needed now is consultation between the Government and bar technicians to develop a reasonable and acceptable compromise. A better legislative product can be expected to emerge from such consultations than from last-minute resolution by committee or conference action necessitated by the sharp time constraints common to crowded Congressional calendars. We urge you to ask your staff and the other Government tax staffs to work with us in developing a proposal that can be general-

ly supported and that will reflect policies of neutrality and consistency with the rest of the transfer tax system.

STATEMENT

Mr. Chairman and Members of the Committee, my name is James B. Lewis. I am Chairman of the Section of Taxation of the American Bar Association. I am pleased to appear as co-spokesman for the American Bar Association with Jackson M. Bruce, Jr., Chairman of the Section of Real Property, Probate and Trust Law.

The American Bar Association has recently modified its position on the generation-skipping transfer tax. In August, 1981, the Association took the position that the generation-skipping transfer tax should be repealed. On November 4, 1981, then ABA President Brink testified in favor of repeal before a subcommittee of the Senate Committee on Finance. At its meeting in Chicago two months ago the Association, while adhering to the view that the present generation-skipping transfer tax provisions be repealed, authorized the two Sections chaired by Mr. Bruce and me to assist this Committee, the Senate Committee on Finance, and the Treasury Department in developing a reasonable alternative.

Mr. Bruce and I are ready to discharge that responsibility by consulting with the staff of this Committee, the other Congressional tax staffs, and the Treasury tax staff in an effort to develop an alternative to the present statute that would be generally acceptable, understandable, administrable, and susceptible of compliance without undue effort. We urge that the alternative should have an appropriate exemption level that would limit the tax to larger estates that would be likely to utilize generation-skipping transfers to save tax and that can afford the costs of compliance.

The principal issues to be considered are:

1. The amount of the exemption level;
2. Whether the exemption level for property in trust should be applied against the value of the property at the time the trust is created or against the value of the property when the tax is imposed.
3. The relationship of the rates of the tax to the rates of the estate and gift taxes;
4. Whether the generation-skipping transfer tax base should be tax-inclusive, like the estate tax, or tax-exclusive, like the gift tax;
5. Whether the tax should be made applicable to outright generation-skipping transfers in which the intervening generation has no interest;
6. Whether the tax should be made applicable to distributions of current income from trusts; and
7. Whether or not more than one generation-skipping tax should be imposed on any transfer and, if so, identification of the appropriate taxable event.

As might be expected, views vary as to how the above questions should be answered. Some of these differences of view are reflected in the three principal current proposals for a revised tax: the proposal of the Treasury Department, the substantially different proposal reflected in the informal draft of the not-yet-completed American Law Institute project, and a third and still different proposal informally developed by a consensus of representatives of ABA and other bar groups.

The third proposal, developed informally by the representatives of the bar groups, has been circulated less widely than the Treasury proposal and the American Law Institute draft. It may be useful to outline the principal elements of the bar proposal:

1. An exemption of \$2.5 million (\$5 million for a married couple), to be measured initially as under the Treasury proposal, with the \$250,000 grandchildren's exclusion eliminated;
2. A flat rate equal to the top estate and gift tax rate;
3. A tax base computed like the gift tax base, i.e., with the tax itself excluded from the base;
4. Direct generation-skipping transfers (i.e., where there is no interest in the intervening generation) to be taxed at one-half the above rate.
5. Taxation of trust income distributions to generations lower than the generation of the grantor's children, with that tax to be an income tax deduction;
6. Only one tax with respect to each generation-skipping trust—i.e., no tax on a distribution of property or the income from property if that property has previously been taxed in that trust; and
7. No tax if the parent of the grandchild predeceased the transferor.

The Treasury Department proposal and the American Law Institute draft have been introduced by Chairman Rostenkowski and Congressman Conable for discus-

sion purposes as H.R. 6260 and H.R. 6261. Those two bills were released with a list of issues on which public comment was requested. I now turn to those issues:

1. Should there be only generation-skipping tax on any transfer? The example is a trust to pay income to the grantor's child for life, and then to the grantor's grandchild for life, with the principal finally distributable to the grantor's great-grandchild. The Treasury, American Law Institute and bar proposals all favor a single generation-skipping tax in that situation. This is a practical compromise arrived at in recognition of the fact that perfect tax neutrality is unattainable.

2. Should the exempt amount for transfers in trust be determined when the trust is created, as the Treasury and bar propose, or when the tax is later imposed, as the American Law Institute study proposes? Although the American Law Institute approach may be theoretically sound, the approach of the Treasury and bar, which shelters from the tax base increase in value in the hands of the trustee, is more acceptable to those who wish to know that specified transfers will be wholly tax-exempt. Here again, the Treasury and bar approach is a practical compromise.

3. Should the surviving spouse be able to utilize the unused exemption of the deceased spouse? The Treasury and bar proposals would permit such utilization, but the American Law Institute draft would not. The Treasury and bar proposals are more consistent with our current income, estate, and gift tax laws, which treat husband and wife as a single taxable unit.

4. Is the exemption from tax of up to \$10,000 per year for distributions to certain trust beneficiaries, proposed by the Treasury, desirable? That issue has not been considered by the ABA or by its Section of Taxation. There may be administrative and compliance justifications for this proposed small exemption.

5. Is a credit against the Federal generation-skipping tax for state generation-skipping taxes on transfers occurring as a result of death, proposed by the Treasury, desirable? That issue has not been considered by the ABA or by its Section of Taxation. The purpose of the credit against the Federal estate tax for state death taxes, introduced in the mid-twenties, was to induce the states to enact uniform death tax statutes. Gradually, that objective is being realized. Of the seventeen states that now impose estate taxes measured exclusively by the federal credit, ten have enacted such statutes within the past five years. A generation-skipping tax credit would have a similar objective.

We are ready to meet with the Congressional and Treasury tax technicians to develop a reasonable and acceptable compromise on these fundamental questions, and also to assist with respect to technical drafting questions. No one of the three proposals on the table is inherently superior to the others in all respects.

We all know from experience that a better legislative product is likely to be achieved by collegial efforts than from last-minute resolution by committee or conference action necessitated by the sharp time constraints common to crowded Congressional calendars. We sincerely recommend that you ask your staff to cooperate with us and the other Government tax staffs in developing an alternative to the present generation-skipping transfer tax that can be generally supported and that will reflect policies of neutrality and consistency with the rest of the transfer tax system.

OFFICIAL POLICY OF THE AMERICAN BAR ASSOCIATION ON THE GENERATION-SKIPPING TRANSFER ACT PROPOSALS TO MODIFY THE SAME

On August 8, 1984 the House of Delegates of the American Bar Association adopted the following resolution upon recommendation of the Section of Taxation and Real Property, Probate and Thrust Law:

REPORT NO. 300

Resolved, That the American Bar Association recommends that the generation-skipping tax provisions contained in Chapter 13, Section 303(d), Section 691(d)(3), and Section 2013(g) of the Internal Revenue Code of 1954, as amended, be repealed, with appropriate conforming amendments.

Further resolved, That the American Bar Association, through its Sections of Taxation and Real Property, Probate and Trust Law assist the appropriate Committees of the Congress, and the Treasury Department, in developing an alternative addressed to the tax policy considerations involved, such alternative to be in a form that is administrable, with respect to which reasonable interpretative regulations can be developed, and in a form which can be complied with by those subject to the tax, and their advisors, with a reasonable application of effort.

Mr. ANTHONY [presiding]. Let's jump to Mr. Bruce now.

**STATEMENT OF JACKSON M. BRUCE, JR., CHAIRMAN, SECTION OF
REAL PROPERTY, PROBATE AND TRUST LAW, AMERICAN BAR
ASSOCIATION**

Mr. BRUCE. Thank you.

I am Jackson Bruce, chairman of the section of real property, probate, and trust law of the American Bar Association. I also wish to echo Mr. Lewis, and I have great pleasure in being here to speak to you today and to join Mr. Lewis in commenting on this act.

We, of course, urge repeal of the present law. We urge it be done as promptly as possibly without necessarily waiting until the substitute can be found because, as you will hear, there are many, many proposals for what that substitute should be.

On the other hand, we echo Mr. Lewis in being more than willing and able to join in trying to formulate a new law. We agree with Mr. Pearlman that the Congress ought to look at the purpose of the generation-skipping tax. We conceive it to be an appropriate question—the question as to whether it is an appropriate backup to the estate and gift tax to prevent avoidance of the tax.

I think the estate and gift taxes should be considered to be excise taxes on the privilege of transferring property. As such, they focus on the ownership of the property. They say nothing about the nature of the frequency of the occurrence of the tax or the identity of the transferee except, of course, with respect to the marital and charitable deductions.

We think that Congress should, therefore, examine whether a generation-skipping tax is a necessary backup. Professor Gutman gave an example with which we concur. It is very likely that when a trust can be established so that the beneficiary of the trust has a life income interest and power to appoint the property to virtually anybody in the world except himself and his estate, a power to withdraw 5 percent of the assets, and management powers in an appointed trustee who is perhaps friendly and who has discretion to distribute the corpus, there is something tantamount to outright ownership.

But we would say, even in those cases, there is one strong incentive against transferring property to a lower generation than the child, and that is the child himself. Anyone who has dealt in the estate planning field knows that there is great pressure from children not to be skipped.

Assuming, however, that Congress is going to have some form of generation-skipping tax dealing with the multiple generation trusts, the question that comes up in the proposals before you is the question of whether there should be a direct skip.

It is a fundamental question, and it is dramatic. The proposition that a direct transfer by a grandparent to a grandchild should be taxed, not only on the assets of the grandparents but with a generation-skipping tax as if the property had passed through the child's hands, is a great departure from the theory of the transfer tax; indeed a tax on direct skips discards the concept of an excise tax on the privilege of transfer of ownership in favor of a concept of generational periodicity.

It must be admitted that certain members of the legal profession brought about some of this thinking because after the 1976 act,

they spoke about layering as a way of skipping a generation for estate tax purposes. But that conclusion ignored two things; it ignored the price paid by the skipped persons who did not really have ownership of the property and who would not have it in the case of a complete bypass to a grandchild.

And it also ignored the fact that it is analytically wrong to assume the transfer is necessary to get the generation-skipping tax avoided. It is intended avoidance of the tax only, if but for the tax, the transferor would have passed it to the skipped generation. That could be wrong in many cases.

The most obvious is the case where the child is deceased and there is no other possible transferee; but there also is the child who is incompetent or alcoholic or simply disliked. The fundamental question is not the motivation of the transferor but whether a well-ordered scheme of death and gift taxation, based on the notion that an excise tax will be levied for the privilege of transfer of ownership, requires a tax on a direct skip when the intervening generation has no interests or powers in the property whatever.

You have to ask what is the evil being prevented? If the child never has ownership of the property, why should there be an excise tax levied on the transfer of the property as if he had had the ownership? Similarly, is there any clear economic or social policy in encouraging concentration of wealth in the hands of children as opposed to dispersal among grandchildren? We think that issue demands close examination by Congress.

Indeed, if what is really wanted is equity among beneficiaries, then we have the wrong system in the first place. We need some other form of system that would tax cumulative acquisitions by beneficiaries. That is the major issue as far as we are concerned.

We also are concerned about the issue of an exemption. We think the amount, whether an exemption or credit, should be very large. Statements have been made that only the superrich can afford to do the kind of generation skipping that is the evil being attacked. If that be the case, the exemption could be very large, \$10 or \$20 million, something of that kind.

We are not advocating that, but that is a corollary to some statements that have been made. In any event, there should be an exemption of great size to take the average taxpayer out of the system, and I think it has to be remembered when talking about estate planning that a million dollars at the time of death is not a great deal. Appreciation in real estate, employee benefits, life insurance, and things like that come up at death, although they are not property that a person has in his lifetime.

In our written statement we have commented on all the specific issues that were asked upon which a response was requested.

Among those, we strongly urge that the gift tax model, the tax exclusive model, be used for the tax base in computation of the tax.

We also believe that the policy and purpose of a generation-skipping tax, if it is needed as a backup for the estate and gift tax, would be sufficiently accomplished by having a generation-skipping tax levied once on distributions to any beneficiary in a generation lower than the child's generation.

We don't think the proper focus should be an assumed parallel of distribution through successive generations. We note that the

Treasury statement presents an alternative amendment to the bill which would tax future generations. We have had no real opportunity to examine that. If anything like that were to be pursued, it should certainly involve repetition of the exemption.

On the issue of exemption versus credit, we have a preference for the exemption in order to take people out of the system up front. We think it will be simpler.

We also agree with some of the statements made that the credit may have more theoretical desirability. The rest of our comments are set forth in our statement, and I will not pursue those here. I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF JACKSON M. BRUCE, JR., SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, AMERICAN BAR ASSOCIATION

SUMMARY

1. The present generation-skipping tax embodied in Chapter 13 of the Internal Revenue Code should be repealed forthwith, without awaiting the development of a suitable replacement.

2. Assuming a replacement tax is needed, Congress should address the underlying policy and purposes of a generation-skipping tax as a backup to the estate and gift taxes which are excise taxes on the privilege of transferring property. (a) As such, there is no need for generational periodicity. (b) As such, there is no need to weigh equities among recipients (as opposed to transferors) whose interests and situations are not similar; and (c) As such, a tax on "direct skips" is inappropriate.

3. If a generation-skipping tax replacement is adopted, it should have at least these features: (a) An exemption or credit large enough to remove from the tax net the large bulk of taxpayers (whose wealth does not permit manipulation of the estate and gift tax system and does not justify its entanglement with a backdrop tax); (b) Exclusion of the tax itself from the tax base, i.e., computation on the gift tax or tax exclusive mode.

4. If a generation-skipping tax replacement is adopted, we also favor, on balance, these features: (a) *De minimis* exclusions of \$10,000; (b) One time taxation regardless of the number of future generations involved; (c) Exclusion of trust income from the tax base; (d) An exemption, as opposed to a credit, to screen out the bulk of transfers; (e) Transferability of any unused exemption or credit to a spouse; and (f) No credit for state generation-skipping tax.

STATEMENT

Mr. Chairman and Committee Members, I am Jackson M. Bruce, Jr., Chairman of the Section of Real Property, Probate and Trust Law of the American Bar Association. I am pleased to appear today on behalf of the Association, along with Mr. James B. Lewis, Chairman of the Section of Taxation. I have attached a Supplemental Statement, amplifying the views of the Section of Real Property, Probate and Trust Law with respect to various generation-skipping issues. I do not intend to read that Supplemental Statement today, but rather to touch on a few highlights and raise some additional points. I will also respond directly to the specific issues on which public comment was requested.

We, of course, urge repeal of the present Chapter 13 for all the reasons long ago agreed to by Treasury and all affected interest groups. We take that repeal to be a given and, as we understand it, the only true issues before Congress are whether such repeal will be accomplished by a revised or new generation-skipping tax, and, if so, what form the new or revised tax will take. We urge immediate repeal of present law without waiting for the preparation of a new law for reasons set out in our Supplemental Statement but we stand ready, with the Tax Section, to assist in defining the structure and detail of any new or replacement law.

1. *The purpose of a generation-skipping tax.*—The first point I think Congress should address in reviewing the generation-skipping legislation on the statute books and the proposed replacements is a fundamental one, namely, what is the purpose sought to be achieved by any form of generation-skipping tax legislation. We do not believe that this issue has ever been squarely addressed in this forum.

The proposition usually advanced is that the generation-skipping tax is necessary as an appropriate backup to prevent avoidance of the estate and gift taxes and to do equity among taxpayers. While it can readily be seen that the gift tax is a necessary backup to prevent avoidance of the estate tax, and to do equity among transferors, it is less apparent that a similar role is required for a generation-skipping tax.

One would start, presumably, from the proposition that the estate and gift taxes are excise taxes on the privilege of transferring property. As such, they focus upon the ownership of the property by the transferor; in general, they say nothing whatever about the frequency of occurrence of the tax or about the identity of the transferee (except of course, for the marital and charitable deductions).

It is this rationale, we believe, that explains the generation-skipping tax that is now on the books. In essence, it was felt that when a trust was created that did not vest the trust property in the hands of a beneficiary in such a manner that it became subject to gift or estate tax in that beneficiary's hands, but that nevertheless provided that beneficiary with powers and interests in the trust property that might be regarded as tantamount to outright ownership, then a tax should be levied on the next passage of title to that property equivalent to the estate and gift tax that would have been triggered if the beneficiary had had outright ownership. One might, of course, question what the degree of interest and powers tantamount to ownership ought to be; one could make a strong case for the inappropriateness of taxing an interest in property amounting only to a bare life estate. On the other hand, if a life estate is coupled with a broad form of special power of appointment, so that the powerholder can appoint the property to anybody in the world excepting himself and his estate and his creditors, and is perhaps further coupled with a lifetime right to withdraw five percent of the assets of the trust on an annual basis and is further coupled with discretionary powers in a friendly trustee to distribute trust corpus to the beneficiary for any worthwhile or desirable purpose, it must be conceded that something close to outright ownership has been achieved.

Even in this extreme case, however, there are few children whose property has been put into trust who would agree that they had the equivalent of outright ownership. I can assure you members of the Congress that there is one powerful element at work in every family situation that militates strongly against the making of generation-skipping transfers and that is the intense pressure from children to receive outright inheritances from their parents rather than to be bypassed. It is probable that where there are vast sums of money such pressure would be less, but I believe that would only occur where the child himself already had very substantial assets.

2. *Taxation of "direct skips"*.—If we assume that Congress has determined that there should be a tax on generation-skipping transfers where the skipped generation has a substantial interest in the property ultimately being transferred to a succeeding generation, a second fundamental question arises and that is whether or not the proposed generation-skipping tax should also tax so-called "direct skips." A direct skip is generally understood to be a transfer of property by the owner to his grandchild or some member of a further successive generation (whether in trust or outright), bypassing his children's generation entirely. A transfer tax system can provide only a tenuous basis at best for taxing a transfer of property from a trust to a grandchild because a child had certain interests in the trust property short of outright ownership as if the child had owned such property. The proposition that a direct transfer by a grandparent to a grandchild should be taxed not only with the estate or gift tax levied upon the grandparent's assets but also a generation-skipping tax as if the property had also passed through the child's hands is an even greater departure from the theory of a transfer tax. Indeed, a tax on direct skips discards the concept of an excise tax on the privilege of the transfer of ownership in favor of a concept of generational periodicity.

The justification most frequently advanced for the necessity for a tax on a direct skip in any generation-skipping transfer scheme is that, without it, wealthy persons will be inclined to "layer" their estates and, in effect, skip a generation of estate taxes within the same family. It must be admitted that certain members of the legal profession have brought about much of this thinking. After the 1976 act, layering was frequently described as one of the methods to avoid the generation-skipping tax. Unfortunately, the conclusion ignores both the price that was paid (by the skipped persons) for such activity and that it is analytically wrong to assume that such a transfer is necessarily intended as an avoidance of the generation-skipping tax. It is an intended avoidance of the tax only if the assumption can be made that, but for the tax, the transferor would have passed the property to the child's generation. That assumption may be wrong in many circumstances. The most obvious is the case where the child is deceased. In such a case, a transfer to a grandchild has no tax avoidance motivation whatever. And there are, of course, many other examples.

The child may be incompetent, alcoholic or simply disliked. Be all that as it may, the fundamental question is not what the motivation of the transferor may be for making the transfer, but whether a well ordered scheme of death and gift taxation, based upon the notion that an excise tax will be levied for the privilege of the transfer of ownership, requires a tax upon a direct skip when the intervening generation has no interests or powers in the property whatsoever.

I would enjoin Congress to examine carefully what the purpose of such a tax may be. What is the evil that is sought to be prevented? If the child never has ownership of the property, why should the excise tax be levied on the transfer of that property to his child as if he had such ownership? Similarly, is there any clear economic or social policy involved in encouraging concentration of wealth in the hands of children as opposed to dispersal of it among grandchildren? The answer usually given is the the direct skip tax is necessary to do fairness among the wealthy and the super-wealthy (those of moderate means are going to do no generation skipping at all for reasons outlined earlier) and to assure that a transfer tax is imposed every generation. The assumption is that similarly situated grandchildren should be treated the same so that each beneficiary will start out with the same sand pile. The problem with that approach, with respect to a direct skip, is that one makes an assumption, which may be totally inaccurate, as to what the child would have done with the property if he had first received it from his parent. The child might have spent the property or passed it along to his child with deductions or other property, all of which might lead to different results in the hands of different recipients.

Indeed, if what is really wanted is equity among beneficiaries rather than transferors, we have the wrong transfer tax system. We need a transfer tax system that is not an excise tax on the privilege of the transfer of ownership, but rather a tax on cumulative acquisitions by beneficiaries, in other words, an accessions tax. In the past, accessions taxes have been examined and rejected either on the basis of complexity or, perhaps, on the basis that they would not occur often enough to collect much tax. An accessions tax makes a good deal of sense if one wishes to treat all similarly situated beneficiaries the same. If that is not the theory, or if one does not want an accessions tax for other reasons, then it seems wrong to be substantial violence to the type of transfer tax system that we have had in this country for over 50 years, namely, an excise on the privilege of the transfer of ownership, by including a direct skip tax in a generation-skipping tax scheme.

Combining a tax on a direct skip with the estate tax reverses normative inheritance tax principles. State inheritance taxes usually have a varying rate structure based on the identity of the recipient of property passing at death. In such systems property passing to lineal descendants (including grandchildren and more remote lineal descendants) is usually taxed at a lower rate than property passing to collateral relatives or to unrelated individuals. The combined estate tax and direct skip tax would do the opposite. The direct skip tax would result in a substantially higher tax on a transfer to a grandchild than on a transfer to a stranger who happens to be less than 37½ years younger than the transferor. Similarly, it would tax transfers to grandchildren at a substantially higher rate than transfers to nieces, nephews, brothers, sisters, etc. To take a simple but graphic example, assume that an individual who had already absorbed his generation-skipping tax exemption or credit gave \$1,000 by will to each of his grandchildren and to the child of a friend. In such a case, assuming a 50% marginal estate tax rate and a 40% generation-skipping tax rate, and assuming that each gift bears its own tax, the child of the friend would receive \$500 net of tax, while the grandchildren would each receive only \$214.29 (because of a \$500 estate tax and a \$285.71 direct skip tax).

I think Congress needs to think about this fundamental underlying issue before plunging willy-nilly into a further expansion and a further complexity of our transfer tax system. In Part IV of our Supplemental Statement, we examine this issue further.

3. Size of exemption.—The second issue of fundamental importance is the size of the exemption from the tax. Generally, rates and exemptions are the business of Congress and do not fall within the special expertise of technical bodies such as the one that I represent. However, there is one aspect of the exemption that involves the practitioner and that is the simple question of whether any tax policy justifies thrusting substantial intrusion and complexity upon the taxpayer of modest or moderate means. I think that a resounding no can be given to that question and, as a consequence, the size of the exemption is of practitioner concern.

Once again, we urge Congress to address, in determining the size of the exemption, the evil they wish to prevent by the generation-skipping tax. If, for example, what they are concerned about is such a concentration of wealth that economic strength could lead to dangerous political power, then we are, of course, talking

about not millions but multiples of millions of dollars and a parallel exemption could be justified. If, on the other hand, the purpose of the tax is to do substantial equity among taxpayers and to prevent the more wealthy from passing on wealth to their grandchildren and future generations at a lower cost than can be done by people of more moderate means who feel constrained to pass the property through their children in some manner, then the exemption level would be lower but would still be very much higher than anything that has been talked about in proposed legislation.

The purpose of the exemption would be to remove from the entanglement of generation-skipping tax complexities the large bulk of taxpayers, who have no generation-skipping tax motivations and who should not be subjected to the expense and complexities of dealing with such a tax when there is no social policy involved in their activities.

4. *Other issues.*—Aside from the two major issues of direct skip and exemption, there are a number of other policy questions worthy of being addressed; these include the question of whether income distributions should be subject to generation-skipping transfers and whether the gift tax or estate tax model should be subject to generation-skipping transfers and whether the gift tax or estate tax model should dictate the tax base, i.e., whether the tax should be on a tax inclusive or tax exclusive basis. These factors have been addressed in our Supplemental Statement. In particular, we believe strongly that the gift tax, or tax exclusive model, should be utilized. In addition, there are specific issues on which public comment was requested and we will address them now.

5. *Taxation of trusts providing for transfers to more than one younger generation.*—We believe that the purpose and policy of a generation-skipping tax, as a backup for the estate and gift tax, will be sufficiently accomplished by having a generation-skipping tax levied once on distributions to any beneficiary in a generation lower than the child's generation. We do not think the proper focus should be upon an assumed parallel of actual distribution through successive generations since there is really no tax profile of the intervening generation members. Assuming a single tax, we would note that tax neutrality is best achieved among trusts by having all generation-skipping taxes apply "going out" rather than "going in", as the ALI Draft (H.R. 6261) does. Thus, for example, under the Treasury Proposal (H.R. 6260) where a trust is established for children and grandchildren, the generation-skipping tax is paid "going out," i.e., when a distribution is made from the trust to a grandchild or when a taxable termination occurs upon the death of the last child.

On the other hand, also under the Treasury Proposal, when a trust is established for grandchildren and great-grandchildren and future generations, the generation-skipping tax would be paid "going in," i.e., when the property is transferred to the trust, and this circumstance may lead drafters to insert a child in a trust where it would otherwise be inappropriate to do so, in order to defer taxation. Since there is to be only one tax, this postponement (as suggested by the ALI Draft) is not of consequence because deferral results in neither economic gain nor loss.

6. *Exemption vs. credit.*—We address this issue in our Supplemental Statement without taking sides. While there is an argument in favor of the credit approach from an equity standpoint, the great advantage of the exemption is the ability to take many people out of the system at the outset. This important simplification probably outweighs the equitable considerations. From the standpoint of the taxpayer, the practitioner and the Treasury, we think that the advantage of an up-front exemption, removing a large portion of people from the system, is the most desirable. In areas of this complexity, it cannot be expected that the average taxpayer will have the capacity to comply properly with the tax rules, nor can it be expected that the Internal Revenue Service will have the staff to police its enforcement. Therefore, we feel it is critical that there be a workable simple rule, which will exempt the bulk of cases from the operation of the generation-skipping transfer tax, and this consideration militates in favor of an exemption as opposed to a credit despite the theoretical merits of a credit approach.

7. *Transferability.*—The next issue upon which comment was requested was the transferability of unused exemption from one spouse to another. We think transferability is appropriate. It comports with the general tax philosophy embodied in the marital deduction and we think a husband and wife should have the ability to use their combined exemptions for generation-skipping tax purposes without having to make underlying property transfers as well. There has been a suggestion that this could lead to an abuse through predeath marriage brokering arrangements. We believe that notion to be farfetched. Should such abuses develop, however, protective

legislation or regulations could be devised; at this point, we would not consider that a realistic concern.

8. *De minimis exception.*—Comment was requested on the appropriateness of a ten thousand dollar per year exemption for taxable distributions to a grandchild from a child-grandchild trust after the transferor's death and the exclusion for transfers that are not taxable gifts. We support these de minimis rules. The heavy baggage and paraphernalia of the generation-skipping tax are disproportionate to the problem of small gifts and distributions. The de minimis exemption might also be helpful to alleviate problems of wasting part of the specific exemption in trusts that are subject to an inclusion ratio, but we consider its most important function to be that of providing a simple mechanism for dealing with distributions of small amounts and without entanglement with the system.

9. *Credit for State taxes.*—The final issue upon which specific comment was requested is whether there should be a credit for state generation-skipping taxes. We think the issue was correctly described in the request for comment, namely, "these credits are in substance revenue sharing with the states." We do not feel we can add any expertise to the question of whether such revenue sharing is appropriate.

From the standpoint of complexity with which practitioners are concerned, the addition of the credit for state death taxes would be likely to add some complexity to the computation and administration of the tax since it would certainly encourage state legislatures to create their own generation-skipping tax. Although a "gap" or "soak-up" tax is usually not complicated to administer in the estate tax context, there are problems where multiple jurisdictions are involved—a more frequent circumstance for trusts than estates. On balance, the issue is that of revenue sharing and is not one upon which we wish to take a strong position; however, avoidance of complexity would lead us to favor rejection of a credit if revenue-sharing issues are not deemed controlling.

I appreciate the opportunity to appear before the committee today and to have our views heard.

SUPPLEMENTAL STATEMENT

The Section of Real Property, Probate and Trust Law affirms the view of the American Bar Association that the generation-skipping tax should be repealed and welcomes this opportunity to convey the Section's comments with respect to Treasury's proposed alternative generation-skipping transfer tax (H.R. 6260, which we refer to as the "Treasury Proposal") and the tentative draft representing the most current work product of the American Law Institute Study on Generation-Skipping Transfers Under the Federal Estate Tax (H.R. 6261, which we refer to as the "ALI Draft") even though it has not received even tentative approval from any ALI body). The Section does not endorse either of these proposals in its entirety.

1. Background of the present generation-skipping tax and the proposed alternatives

The present generation-skipping tax, embodied in Chapter 13 of the Internal Revenue Code, became law in 1976 as part of the Tax Reform Act of 1976. While there were some hearings with respect to that legislation in general, the generation-skipping tax provisions were not reviewed at length or in depth by any Section of the American Bar Association, or any of the myriad of other interested professional organizations. Neither was there a substantial degree of time devoted by Congress to the consideration of these provisions. Chapter 13, as enacted, has been a failure. Not only has it met with widespread and well founded criticism by professional organizations, but the Internal Revenue Service itself has found the law practically impossible to administer.

In August, 1981, the American Bar Association urged repeal of the law because it was found to be unworkable. In November, 1981, the Treasury Department publicly admitted that there were severe problems with the law and at a hearing before the Subcommittee on Estate and Gift Taxation of the Senate Finance Committee, suggested several possible ways in which the law could be amended to make it more comprehensible and workable. In December, 1982, a retroactive moratorium of the law's application passed the Senate, but in the House-Senate Conference Committee deliberations the moratorium was dropped.

On April 29, 1983, the Treasury Department released in essay form a proposal that would fundamentally change the generation-skipping tax in order to "simplify and improve" it. In presenting its proposal, Treasury went even further than it had in November, 1981 by stating that the present law is too broad in scope, too complex for comprehension, unworkable from an administrative standpoint, inequitable in application, ineffective in taxing generation-skipping transfers, unfair and lacking

in logical consistency. Consistent with these conclusions, the Treasury Department at that time stated that it favored retroactive repeal of the existing generation-skipping transfer tax. The American Bar Association agrees with Treasury's characterizations of the problems with the present Chapter 13 and its suggested solution. It does not, however, agree with Treasury that the retroactive repeal of the existing generation-skipping tax should await the enactment of new generation-skipping tax provisions.

Not surprisingly in view of the complexity involved, it took the Treasury until September, 1983, to develop a discussion draft of statutory language to implement its April 29, 1983 proposal. This discussion draft was submitted to a select group of practitioners, including several members of this Section, for technical (as opposed to policy) comments on the workability of the statutes. The Section acted quickly, in conjunction with a subcommittee of the Estate and Gift Tax Committee of the American College of Probate Counsel, and orally conveyed to Treasury areas where practitioners saw potential technical problems with the statutory language. On November 9, 1983, the Treasury issued its "first draft language" under the April 29, 1983 proposal to Senator Symms, which in many (but not all) instances incorporated changes proposed by the Section and the College. Two subsequent drafts were later issued by Treasury—one dated January 6, 1984 and the other dated February 2, 1984.

The latest draft is still being studied by the Section to determine its technical workability. Some preliminary conclusions have been reached, however. This past April, despite Treasury's proposal and the ALI project, the Senate voted to repeal the present generation-skipping tax and did not offer an alternative. However, in June the repeal provision was dropped in the House-Senate Conference Committee deliberations. Then, on July 2, 1984, this hearing was scheduled.

At the same time that Treasury was drafting its alternative to the present law, the American Law Institute was engaged in a comprehensive Study on Generation-skipping Transfers Under the Federal Estate Tax. It began its Study amid the growing dissatisfaction with the present Chapter 13 and the continual calls for repeal. The ALI Reporters, with the assistance of their distinguished Tax Advisory Group and Consultants, developed a Discussion Draft, dated March 28, 1984 which was submitted by the Council to the members of the American Law Institute for discussion. This comprehensive draft contains an extensive discussion of the reasons for a tax on generation-skipping transfers as well as a statutory scheme of taxation. Proposed statutory language has been drafted by the ALI Reporters to supplement the detailed commentary and explanations included in the ALI Draft.

II. Need for immediate repeal of chapter 13

Conscientious efforts are being made by both the legal community and the Treasury Department to develop a substitute for the present Chapter 13. However, as the foregoing timetable reveals, developing alternatives is an extremely difficult, time consuming and drawn out process. In the meantime, Congress should not impose upon the citizens of this country a statute that the vast majority of lawyers are incapable of understanding, that the government's own enforcement arm is incapable of administering, and that almost all informed individuals believe must eventually be repealed. This situation simply perpetuates the quagmire in which taxpayers and their advisors have had to work for the last eight years (since the statute was passed in 1976).

Every year from 1976 through the present, lawyers have been obligated to attempt to comply with the present law, which has resulted in unnecessary legal fees charged to clients and, occasionally, the payment of a tax that is most likely to be retroactively repealed and is not being effectively enforced. Furthermore, many taxpayers now find themselves in the incongruous position of not having to consider the federal gift or estate taxes in estate planning matters by reason of existing exemptions but at the same time having to take into consideration the implications of a soon to be extinct (or at least fundamentally changed) generation-skipping tax.

Although it has been eight years since the statute's passage, no final regulations with respect to any substantive provisions of the act have ever been issued and now, presumably, they never will be. Everyone agrees that the present statute will not survive as we know it. In addition, Treasury has categorized regulations under the generation-skipping tax law as among those that cannot even be scheduled for preparation during the next 15 months.

It has taken almost three years from Treasury's public acknowledgment of the unworkability of Chapter 13 for this committee to schedule hearings on alternatives. The complexity of the issues involved requires that these alternatives be given careful and detailed study so that the mistakes of 1976 will not be repeated. The delay

in beginning this study at the Congressional level has not been the fault of the practitioners. We have been pressing for hearings for years. Practitioners and their clients should not continue to be penalized for the failure of Congress to develop a new and workable alternative to the existing Chapter 13. While study continues on the solution, the present statute should be repealed.

III. The Treasury and ALI proposals in general

Both Treasury and the ALI are to be commended for having given careful thought to possible alternatives to the present Chapter 13. Detailed drafts of status incorporating the concepts of both have been prepared, and each of these drafts lead to a substantial improvement over present generation-skipping tax law. The Section disagrees fundamentally with certain aspects of both proposals, however, and we will now address the major aspects of the two proposals that the Section believes should be deleted or changed in any replacement for the present Chapter 13. In doing this, we do not mean to detract from the many virtues of the two proposals.

First, we note that both proposals are intended to limit the generation-skipping tax to very wealthy individuals or trusts. A generation-skipping tax is justified by its adherents as necessary to prevent taxpayers from avoiding the estate and gift tax by means of certain types of generation-skipping transfers. Because an equitable generation-skipping tax is certain to be complex and administratively burdensome, it is crucial that it apply only to those who are otherwise subject to the estate and gift tax and who have the additional means to seek to avoid those taxes through generation-skipping transfers. The exemption (or credit) level must, at a minimum, be high enough to exclude taxpayers who do not fit within this description. Viewed from this vantage point, the Section believes that the levels set forth in both Treasury's Proposal and the ALI draft proposal, although an improvement over current law, are not high enough.

The other major aspects of the two proposals with which we strongly disagree are:

1. Any broadening of the scope of the generation-skipping tax to include a tax on direct transfers to persons more than one generation younger than the testator or donor;
2. Any broadening of the application of the tax to include a generation-skipping tax on distributions of trust income to a person more than one generation below the testator or donor; and
3. Treasury's use of the estate tax as a model for the appropriate method of taxing distributions from generation-skipping trusts, rather than the more appropriate gift tax model.

IV. Congress should not enact a new "direct skip tax"

The proposal to apply the generation-skipping tax to direct transfers that skip a generation (for example, an outright gift from grandparent to grandchild) is the most objectionable provision of the two proposals; it would add still another tax to our transfer tax system, and would, moreover, be a transfer tax without a transfer.

Chapter 13 as conceived, enacted, and currently in force, added a new levy to our transfer tax system that purports to tax "transfers" of property from the holder of a power or interest in that property to the next succeeding beneficiary. The proposed direct-skip tax (referred to as the "DST"), purports to impose a transfer tax in addition to the gift or estate tax imposed on the original donor or the donor's estate, as if there were also a transfer from a person in the intermediate generation to the actual recipient in the next younger generation, even though no such transfer did or could have taken place because the intermediate generation person never had any interest or power in the property.

When Congress enacted the present Chapter 13, it was concerned with the enjoyment of wealth by intervening generations without the payment of transfer taxes when that enjoyment ceased and the property passed to a younger generation. Congress explicitly was not then concerned with gifts to grandchildren and more remote descendants where no one else had any enjoyment of the property. Despite its name, the generation-skipping transfer tax was originally conceived to tax those transfers that did not in fact skip a generation. A DST would be the first tax under our transfer tax system imposed with total disregard for any economic benefit from or power over the property being taxed. It represents a concept that has been rejected by Congress on several earlier occasions and the Section believes that it should be rejected again.

Three arguments have been advanced in defense of this dramatic and fundamental change in our transfer tax system and usual concepts of death taxation.

First, the tax is claimed to be necessary in order to prevent a tax incentive to "skip" generations. We agree that the present Chapter 13 might have served as an incentive to certain extremely wealthy taxpayers to skip a generation; however, the number of taxpayers with wealth sufficient to enable them to bypass their children entirely for the sole purpose of avoiding the tax is very few indeed, much smaller than those who might be tempted to create a trust for children in order to reduce the children's estate taxes. As a result, a DST will discourage legitimate non-tax motivated transfers to grandchildren (and others "assigned" to their generation or a lower generation). (To prevent this result, if there is to be a DST, any exemption or credit applicable to such transfers should be very large—far larger than the amounts presently under consideration and far larger than the amount necessary for a generation-skipping tax that does not include a DST.)

The corollary to the argument that lack of a DST encourages transfers that skip children is the argument that by exacting a DST, Congress would be actively discouraging gifts to grandchildren in favor of gifts to children and/or strangers. One may ask if this is in fact appropriate as a matter of public policy. If one of the purposes behind our transfer tax system is redistribution of wealth, more redistribution is achieved by encouraging transferors to split their transfers between children and grandchildren than by encouraging them to make all transfers to children. The DST would intentionally encourage concentration of family wealth in the hands of children. Some might say that this is against the public interest.

The second reason sometimes advanced in support of a DST is that it is needed for "simplicity." We do not believe that a DST would significantly increase simplicity. Both Treasury's proposal and the ALI Draft indicate that it would be possible to excise the DST without unduly complicating these proposals. The DST in both Treasury's proposal and the ALI Draft is, after all, the equivalent of a new transfer tax, independent in policy and operation from the basic generation-skipping tax. Its mere existence adds complexity, not simplicity, to our transfer tax system.

The third reason advanced in support of a DST is that "logical consistency" requires that our transfer tax system exact a tax at least once per generation. We cannot accept this argument. If "logical consistency" requires a tax once per generation, the corollary is that a tax should not be exacted more than once per generation. Specifically, if we are moving toward a generational concept in imposing transfer taxes then we should also exempt from tax all intra-generational (or higher generation) transfers so that no tax is imposed on gifts to siblings or parents. It is not logical or fair to twice tax a transfer from grandparent to grandchild because property passes down two generations when our system taxes a transfer from brother to sister even though it does not pass down even one generation. As long as we have a tax system based on transfers with no exclusions for intra-generational transfers (other than between spouses), we should not impose a double tax on inter-generational transfers where only one transfer has in fact taken place.

As a result of the DST, transfer taxes will be based on the right to receive property rather than the right to transfer it. The recipient's age and relationship to the donor will determine the rate of tax. Thus, we will have some elements of an inheritance tax rather than a true estate tax and this inheritance tax will be based on different concepts than those underlying state inheritance taxes. If equity among recipients rather than transferors, is the goal, the proper model is an accessions tax.

V. The generation-skipping tax should not apply to distributions of current accounting income from trusts

Present Chapter 13 does not tax distributions of trust accounting income. Both the Treasury's Proposal and the ALI Draft would broaden the scope of Chapter 13 to tax distributions of current trust accounting income to a grandchild or other beneficiary in the grandchild's generation. (As a partial amelioration of the resulting double tax, the proposals would allow the distributee to deduct the generation-skipping tax from his income.)

We submit that Congress's effort should be to replace an unenforceable tax with a simpler, readily enforceable tax, not to expand and complicate it. Ignoring for the moment state and local income taxes, the combined federal income tax and Chapter 13 bite, even with a deduction allowed (for example by § 164(a)(6) of the Treasury Proposal) can be punitive. The federal income tax (50 percent) and Chapter 13 tax (40 percent) will in most cases take a \$70 bite out of every \$100 of income paid to a grandchild from a trust in which his parent has a beneficial interest, leaving the grandchild with \$30.

This committee's report on the present Chapter 13 as enacted in 1976 [House Report 94-1380 (Report of Ways and Means Committee on H.R. 14844) p. 52.] stated

"[t]he rule with respect to accounting income is primarily a rule of administrative convenience in cases where the trustee is required, or decides under discretionary powers, to distribute all of the trust income each year." We submit that this reason still exists, and that it may even more compelling at this juncture, when the Administration and Congress are trying to simplify not only the generation-skipping tax but also the entire income tax situation. Subjecting income to the Chapter 13 tax will require frequent generation-skipping tax returns for modest amounts. Questions may also arise under the state tax apportionment, statutes and/or imprecise tax clauses in the trust instrument as to the allocation of the tax—which, after all, is not an income tax, but instead is a phantom gift/estate tax.

For these reasons, revised Chapter 13¹ should retain the present definition of "taxable distribution" which excludes current accounting income.

VI. The gift tax model should dictate the tax base

Under present law, gift taxes are imposed on a tax-exclusive basis; the payment of gift taxes by the donor is not itself a taxable gift. Estate taxes, on the other hand, are tax-inclusive in that funds that will go to pay estate taxes are included in the decedent's taxable estate. The ALI Draft generally advocates a tax-exclusive generation-skipping scheme with most transfers taxed on the gift tax model. The Treasury Department's proposal also adopts a tax-exclusive approach to direct generation-skipping transfers. With respect to generation-skipping transfers from trusts, however, Treasury proposes an estate tax (tax-inclusive) model. The estate tax model is to be applied to both taxable distributions and taxable terminations, even if the "skipped" member of the intervening generation is still living. Both the distinction between direct transfers and transfers in trust and the decision to use the estate tax model for taxable distributions from trusts are irrational and inconsistent with Treasury's own basic arguments.

The taxation of generation-skipping transfers made during the lifetime of a member of the intervening generation is intended to approximate the tax consequences of a transfer to that member of the intervening generation, followed by a lifetime transfer by him or her, which would be subject to the gift tax. Thus, the proposals to tax such generation-skipping transfers should adopt the gift tax model. The Treasury Department has proposed using the gift tax model for its DST but not for gift in trust. It has suggested no reason for this distinction and we cannot conceive of any rationale. As a result of this distinction, under the Treasury proposal, assuming top gift and estate tax rates of 50%, a direct net transfer of \$100 to a grandchild would cost \$110 in gift and generation-skipping taxes while the same transfer through a generation-skipping trust would attract \$150 of taxes, a 36% differential.

There are two significant consequences of this substantial differential in tax rate. First it increases the necessity of substantial planning with respect to generation-skipping transfers. Second, it dramatically reduces any simplicity achieved by Treasury in taxing direct skips by forcing a determination to be made as whether a particular transfer was made by means of a direct skip or by means of a transfer in a trust in which an intermediate generation member has an interest.

The ALI Draft on the other hand adopts the gift tax model in all cases except "taxable terminations," which are defined in such a way as to occur very infrequently. Nevertheless, we believe that even this distinction in the ALI draft adds unnecessary complexity.

It must be recognized that the benefits of a flat tax rate are undone when a substantial rate differential occurs between two different methods of making the same transfer. As a result, it is crucial that the same model (gift tax or estate tax) be used for all generation-skipping transfers and the gift tax model is the proper model. It is clearly the most appropriate model when the generation-skipping transfer is made at a time when the member of the intermediate generation is still alive. It also represents the only appropriate approach in the case of a direct skip transfer where the member of the intermediate generation is already deceased so that no transfer could in fact have been made to that member. (In such a case, it would make no sense to impose the tax as if the predeceased individual had received the property, had the use of the property during his or her lifetime and then transferred it on death to the actual recipient in the next generation.)

The planning costs are high whenever the choice of method of transfer may result in sharply differing methods of taxation. We believe that because the gift model, is more appropriate for most generation-skipping transfers, these planning costs should be avoided by taxing all generation-skipping transfers on the gift tax model.

VII. Technical review

From a technical standpoint, we note that the two proposals use different methods of excluding all but the most wealthy taxpayers from the application of the tax. We hope to assist your deliberations by briefly comparing these two approaches.

The major difference between a credit (ALI Draft) and an exemption (Treasury Proposal) is that under the exemption approach the decision as to whether the generation-skipping tax will apply to a particular trust is made when property is initially placed in the trust, while under the credit approach this decision is made as property is distributed out of the trust in such a way as to attract the tax. Thus, under an exemption system, whenever a trust is determined to be exempt from tax it need never again concern itself with generation-skipping tax, while under a credit system, the decision as to whether a trust is subject to generation-skipping tax can never be made definitively during the term of the trust, or at least as long as appreciation is possible.

The effect is that the exemption approach achieves greater simplicity in both the administration and application of the tax, giving a far larger group of taxpayers, practitioners, and Treasury personnel, the ability to ignore the tax altogether, while the credit approach appears to have greater tax equity and revenue-raising potential.

Under the credit system, recordkeeping and tax reporting must take place throughout the entire life of all potentially generation-skipping trusts since distributions from the trust may eventually use up the credit. This means that trustees and all practitioners involved with trusts will always need to concern themselves with the generation-skipping tax under the ALI model. On the other hand, under the exemption approach these duties will exist only with regard to taxpayers over the exemption level and practitioners who advise such taxpayers.

Under the exemption approach, because a trust, once exempt, is always exempt, a generation-skipping tax can never be exacted from it regardless of the size to which it grows. On the other hand, under the ALI Draft's credit, a trust that grows sufficiently large to warrant the imposition of a generation-skipping tax will become subject to it.

Our Section is still undertaking a technical review of Treasury's proposal and the ALI Draft so that, if either of these is to make its way through the legislative process, we will be able to assist in curing technical problems. We will submit further written commentary as and when appropriate.

Mr. ANTHONY. Thank you, Mr. Bruce.

Mr. Moore.

STATEMENT OF MALCOLM A. MOORE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF PROBATE COUNSEL

Mr. MOORE. I am Malcolm Moore, chairman of the Estate and Gift Tax Committee of the American College of Probate Counsel.

The college is a group of more than 2,500 lawyers who specialize in estate and trust matters. It is composed of seasoned and experienced practitioners, and I think we bring a useful perspective to this whole issue of generation skipping. We have been involved with it even before the 1976 act, and extensively since then.

The position of the college continues to be, along with everyone else, including Treasury, that the present chapter 13 has got to go. We have had it 8 years in operation. Everyone agrees it really can't be administered; it has been a failure.

I think you have to look at what the ground rules for any substitute, if there is to be one, should be. We see two. One is that it only apply to transfers which we perceive to be the problem—the long-term transfers of great wealth by taxpayers over generation after generation—the \$30 million kind of example, such as Mr. Pearlman gave, and not the \$1 million estate consisting of employee benefits, life insurance and real estate which Mr. Bruce referred to. So,

we feel that the scope of the tax has to be narrow to address the problem.

Second, and very important, it has to be understandable to clients and advisers and administrable by IRS; the current chapter 13 flunks this test, also.

Given those two general criteria against which we will judge any substitute, we have the following thoughts about the substitute proposals talked about thus far. With respect to the issue of exemption versus credit, we prefer the exemption for the reasons that have been stated. It takes taxpayers out of the system at the beginning. It eliminates recordkeeping for taxpayers, for fiduciaries and for the IRS, which is the most important consideration.

We feel the credit approach, while perhaps more equitable, simply gets us into the same morass we have been in with respect to chapter 13 in terms of complexity.

As far as the amount of the exemption, we are in favor of an increased exemption; \$1 million sounds like a lot when you say it, but when you really address the problem that we are trying to get at, it is not the person who has \$1 million who is making generation-skipping transfers; it is the person with \$30 million.

The \$1 million exemption amount really isn't tied to anything particular; neither is the ALI credit approach. Perhaps something more logical to tie it to would be the figure at which the top estate and gift tax transfer rates cut in—currently \$3 million. That is, I suppose, as good a definition as any that Congress has made of what constitutes great wealth. It is the amount at which the top transfer tax rate cuts in. So we would say that that would be a much better choice than the \$1 million, one, because it has more logic, and two, because it narrows the scope of the tax.

As far as rates are concerned, when you combine the generation skipping rates with the gift and estate tax rates, and you throw in the income tax if you tax income distributions, we feel the rates are entirely too high.

In the end, for a taxable termination, for example, it is going to take \$75 of assets to get \$25 to the children. In other words, it will cost the taxpayer \$75 to make a transfer of \$25. We submit that that is entirely too great a price to pay.

In terms of taxing direct skips—everyone will comment on that and we will, too—we certainly feel that this should not be a part of this system for reasons a number of people have mentioned. Certainly—and I think Mr. Pearlman has said this, and Mr. Gutman has, and Congressman Archer suggested it—taxing the direct skip is a step toward adopting a view that the tax should be imposed at each generational level. We submit that that is a major question which, if it is going to be addressed, should certainly not be addressed in the narrow context of these hearings.

The idea of taxing wealth every generation has never been part of our transfer tax system. Indeed, one could say, why not tax every second or third generation? If you say there should be a tax every generation, which the direct skip is a step toward, shouldn't there be no tax for transfers between brothers and sisters or transfers from a child back to a parent? Certainly that, it seems to me, can be a logical conclusion if you adopt the proposition that direct skips should be taxed.

You get strange results if you tax direct skips—some have been alluded to, but one I will mention. I don't think I could explain to a single client why he should pay a heavier tax in making a transfer to a grandchild than to a nephew, and yet that is the result if you impose a tax on direct skips.

I would reiterate what Mr. Bruce said; direct skipping transfers certainly seem to me to not be against economic policy; indeed it should cut the other way. Grandchildren are typically at an entrepreneurial age. Aren't they the ones who should have use of the money rather than tying it up in the older generation to be kept until the child's death?

We also have views on some of the other issues that the committee has asked comment on. They are included in the written material.

I would only say one word about the effective date. We believe that whatever legislation comes about after repeal of present chapter 13 should not be retroactively applied to preexisting irrevocable trusts or prior transfers of property.

The American College of Probate Counsel appreciates the opportunity to make this statement before the committee today.

[The prepared statement follows:]

STATEMENT OF MALCOLM A. MOORE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE,
AMERICAN COLLEGE OF PROBATE COUNSEL

This statement has been prepared by the Estate and Gift Tax Committee of the American College of Probate Counsel (the "College"), and the positions presented here have been specifically approved either by the Board of Regents or the Executive Committee of the Board of Regents of the College and are submitted at the express direction of the President of the College, J. Thomas Eubank, Esq. of Houston, Texas. The membership of the Board of Regents and the Estate and Gift Tax Committee of the College is listed on Exhibit A attached to this statement.

The College is grateful for being given the opportunity to appear before this distinguished Committee to express the views of our membership (which is composed of more than 2,450 experienced and seasoned lawyers who specialize in the practice of trusts and estates law and related tax matters) concerning the generation skipping transfer tax. The improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country, has been a major and continuing effort of the College from the date it was first organized over 35 years ago. We welcome and accept once again the challenge of working with the Congress to find additional ways for improving and simplifying the nation's transfer tax laws.

1. *Present position of the American College of Probate Counsel.*—The College's Board of Regents has steadfastly endorsed the retroactive repeal of Chapter 13 of the Internal Revenue Code of 1954, and continues to take that position. The Regents have not formally taken any position on whether or not repeal of Chapter 13 should be followed at some point by the adoption of an alternative tax. The Board is not scheduled to meet until mid-October and hence I, on behalf of the College, as Chairman of its Estate and Gift Tax Committee, cannot at this hearing take any affirmative position regarding a substitute to the present tax. However, in the spirit of constructive debate about the generation skipping transfer tax, and having in mind the ground rules set down by the Chairman in announcing these hearings, the College does express the following thoughts and concerns about the Treasury proposal now embodied in statutory form as H.R. 6260, and to a lesser extent, because of inadequate opportunity to review its provisions, the so-called ALI proposal embodied in H.R. 6261.

H.R. 6260 and H.R. 6261 have only been available to the various professional groups, including the American college of probate counsel, since September 19th. Seven working days is hardly sufficient time for thoughtful and complete evaluation of the proposals contained in those bills. However, even given the short period of time that we have had to review them, the College remains unconvinced that either of the approaches as embodied in the proposed legislation provides a really viable,

tax-neutral alternative to present Chapter 13, which everyone agrees should be repealed. The College now has reservations about whether it is going to be possible to produce an alternative approach which is tax-neutral and which meets the objections to current Chapter 13.

The involvement of the College in the generation-skipping tax debate has been a long and significant one. The College has heretofore provided technical comments on the Treasury proposal to various staff members of the Congressional tax writing committees and has participated (together with other groups) in extended discussions with the Treasury Department and Congressional staff members concerning possible revisions to the Treasury proposal, and alternative approaches.

2. *Scope of the generation skipping tax.*—The College has had essentially two reasons for favoring repeal of current Chapter 13. The first is that from the extensive experience of the Fellows of the College, long-term generation skipping transfers take place very infrequently, and only in families of great wealth. Since the instances in which such transfers occur are very few, the tax should only apply in those few cases. However, present Chapter 13 is potentially applicable to perhaps the majority of inter vivos and testamentary transfers in trust. Any substitute should apply, if at all, only in those circumstances involving long-term, tax-motivated generation-skipping transfers of large amounts. The second objection to present Chapter 13, voiced by all groups, including the Treasury Department, is that the tax is too complicated, too difficult for the average practitioner to understand, too intrusive on a fiduciary trying to comply with the law in terms of record keeping requirements, and virtually impossible for the Internal Revenue Service to administer. Any substitute tax must respond to these two general criticisms of present law.

3. *The Treasury proposal—H.R. 6260.*—The Treasury proposal embodied in H.R. 6260 responds in part to the main concerns expressed above. The use of an "up-front" exemption means that all transfers which fall within the exemption will never be subject to generation skipping tax; this is appropriate for the reasons stated. Once a transfer is subject to the tax, the administration and enforceability of the law is simpler than is the case with current Chapter 13, and than would be the case if a credit, rather than an exemption, is used, which is the approach followed in H.R. 6261. Since a large number of transfers will never be subject to the tax, burdensome record keeping is eliminated for those transfers. When a transfer is subject to the tax, the use of a single rate simplifies calculation of the tax.

While H.R. 6260 makes the progress in meeting the objections of the College to present Chapter 13, the College feels that significant changes must be made to it to meet fully its objections to the current law.

3. *The "ALI" proposal—H.R. 6261.*—H.R. 6261 incorporates what is described as a "Discussion Draft of the American Law Institute." It is understanding of the College, many of whose members attended the meeting of the American Law Institute last May, that this proposed Legislation is largely predicated upon the work of one of the two reporters (we understand that there is another version which did not call for a tax on a direct skip) and hence does not represent the official views of the American Law Institute.

Unlike H.R. 6260, which has been available for study in form since February of this year, the legislative embodiment in H.R. 6261 is new and we have not (as indicated above) had the opportunity, because of time structures, to analyze it in detail.

The basic difference between the Treasury proposal and what, for convenience only, we will refer to as the ALI proposal, is that the former provides for an exemption and the latter takes a credit approach. The amount of the credit is an arbitrary construct. It assumes a \$600,000 unified transfer tax credit and a maximum transfer tax rate of 50%—neither of which is presently the case. The tax on the difference between \$600,000 and \$2,500,000 was then computed at \$834,000 and half of that amount or \$417,000 was utilized as the credit. Obviously, there are many other ways in which the credit amount could be computed.

The College prefers the exemption approach. While as noted below we believe that the \$1,000,000 exemption proposed by the Treasury is entirely too small, this is clearly the approach which could keep a significant number of trusts out of the system, and once they are out of the system, they would be forever out of the system. To the contrary, the ALI credit approach means that no trust, even one which starts with a corpus of \$100, could be assured of being forever out of the system and would require trustees to keep track of distributions from the fund to determine when, if ever, the trust would be subject to the generation-skipping tax. This imposes an undue burden, particularly upon individual fiduciaries of what are initially small trusts. It also fails to respond to our second significant criticism of present Chapter 13—that it is entirely too burdensome on practitioners, trustees, and the Internal Revenue Service itself.

5. *Exemptions, credits and rates.*—As stated above, the College's position with respect to the generation skipping tax is that it should apply only to long term transfers by taxpayers of great wealth. While it is difficult to arrive at a dollar amount over which a taxpayer would be considered to be in this "great" wealth category, it is certainly relevant to look at the level of wealth which Congress has decided should be subjected to the top transfer tax rate. That rate is currently 55%, and applies to gifts of property, and estates, in excess of \$3,000,000. The College submits that it would be logical to apply the generation skipping tax to transfers in excess of the amount at which the top transfer tax rate cuts in. This is as good a definition of "wealth" as we now have, and more logical than the proposed \$1,000,000 exemption in H.R. 6260, or the \$417,000 credit used in H.R. 6261. The Treasury itself has made reference to the top transfer tax rate in setting the flat rate to be applied for generation skipping tax purposes (the rate of generation skipping tax under H.R. 6260 is 80% of the highest marginal transfer tax rate). Should the top rate decline to 50%, as it was schedule to do in 1985, it could be that the exemption from the generation skipping tax should be \$2,500,000, not \$3,000,000, since that will then be the level at which the top transfer tax rate would become applicable.

Given the rapid appreciation which has occurred nationally over the last several years in residential real property values, many family homes theretofore considered "modest" are worth hundreds of thousands of dollars. The presence of such a residence, combined with significant employee benefits (which after 1984 will be completely subject to estate tax), life insurance, and reasonable amounts of other property, means that a large number of persons who would never have considered themselves wealthy, much less of great wealth, have estates in excess of \$1,000,000. Such persons should not be subject to a tax which should be designed to curb generation-skipping transfers by persons of great wealth, nor should their estate plans be subject to the complexity that still is present under H.R. 6260 (albeit reduced) and H.R. 6261.

The attraction of a flat rate of tax is its simplicity. However, a flat rate of 80 percent of the top estate and gift tax rate adopted in H.R. 6260, and the flat rate of 100% of the top rates adopted in H.R. 6261, when combined with payment of a gift or estate tax, are both too high. Either the level of exemption should be used at which the top gift and estate tax transfer tax rates take effect, or if there is to be a much lower exemption for generation skipping transfers (such as the \$1,000,000 amount suggested by Treasury), then the rate of tax should be substantially less. Since 55 percent is the top tax rate applied to a gift or estate and there is a top rate of 50 percent on individual income tax, what is the rationale or fairness of a combined tax in excess of 70 percent (and even higher if the tax inclusive rather than tax exclusive method is used) for generation skipping transfers? Either the exemptions should go up, or the rates should come down. The \$10,000 de minimus yearly exemption contained in H.R. 6260 is helpful in removing from the system insignificant yearly transfers. The College favors its retention although wishes its provisions were simpler and less restrictive in terms of application.

H.R. 6260 allows the generation-skipping tax exemption to be freely transferable between spouses. The college believes that such free transferability is entirely appropriate; at the very least it puts those taxpayers in a separate property state on a par with taxpayers in a community property state without the necessity for ill-advised or inappropriate transfers to third parties or between the spouses. The material accompanying the release of the two legislative proposals suggested that some people feel that serious potential abuses lurk in the free transferability proposal. The College views those fears to be unfounded, and in particular thinks that the suggestion that there would be "trafficking" in unused generation-skipping tax exemptions borders on the absurd. The college is composed of experienced probate practitioners whose experience tells us that clients simply do not take such a serious step as getting married to avail themselves of an additional exemption for transfer tax purposes. The College submits that no empirical data can be adduced for the suggested problems with transferability and that such assertions and the request for comment thereon unnecessarily diverts Congress' attention from much more basic issues. If it can ever be established that there is a demonstrable problem with transferability, there could be some kind of limit on the number of exemptions which could be utilized by one person by reason of spousal transfers but the College believes that no such restrictions are necessary and that they would merely result in further complexity to an area already overburdened with it.

Some have said that it is only the business of Congress to set exemption levels and fix tax rates. The College disagrees with this assertion when the whole premise of the tax being discussed is that it should apply in limited situations and that the record keeping and complexities which exist when the tax applies should be imposed

only when significant transfers are involved. The scope of the tax is thus enormously important in determining what, if any, alternative the College can support; therefore we feel it incumbent upon us to comment on the level of exemption and the rate of tax.

6. Direct Generation Skipping Transfers.—For the first time, a Congressional Committee is hearing testimony concerning the new tax on direct generation skipping transfers.

Both H.R. 6260 and H.R. 6261 imposes such a tax. However, we understand that there were sharply divergent views concerning the direct skip expressed by the participants in the ALI proposal, with a significant number opposing imposition of the tax on a so-called direct skip.

This new tax is proposed under the guise of reforming and simplifying present Chapter 13. This new tax would be imposed in situations which have never before provoked such a tax and which were clearly beyond the contemplation of Congress when it enacted the present law. Imposing a tax on direct transfers does not reform existing law. It goes far beyond the preceived evil which Congress saw in enacting the present Chapter 13, viz., that a person should not be able to enjoy most of the economic benefits of property and at the same time not have it taxed on his or her death when that property is passed on to his or her issue.

The basic reason that a tax on direct generation-skipping transfers has no place in our present tax system is that no real transfer is taking place in the sense that the word "transfer" has always been used in our present tax system. Similarly, there is no transferor. The theory of the tax is that property has been transferred from the parent to a child, and then from a child to a grandchild. However, when a grandparent transfers property directly to a grandchild, there has been no transfer by the parent, which is the "transfer" to which the tax purportedly relates.

Certainly there are instances where property subject to a person's power or enjoyment has been included in that person's estate and that person has been regarded as a "deemed" transferor (e.g., general power of appointment taxed under Section 2041 or qualified terminable income property taxed under Section 2044) but as noted above, in a direct generation skipping transfer the phantom transferor has no benefits from, or power over, the "transferred" property. The imposition of such a tax represents a fundamental divergence from existing transfer tax principles, and Congress should consider its implications most carefully before adopting it.

This new tax applies where a grandparent gives or bequeaths property directly (either outright or in trust) to a grandchild even though no child has any interest whatsoever in the gift or bequest. It is an additional gift tax, indeed an inheritance tax, imposed against a prescribed class which in most situations will be grandchildren.

I doubt that a single Fellow of the College, all of whom are experienced probate practitioners, could explain to any client's satisfaction why transfers made either during life or at death to a grandchild are subject to a tax which would not be imposed upon an identical transfer to a niece or nephew. The vast majority of clients would ask why the tax laws do not instead favor grandchildren, as opposed to more remote beneficiaries.

What is the underlying rationale for a tax on such transfers? There appears to be a presumption that, in the normal course, property passes from parent to child and from child to grandchild. This, of course, has not been empirically examined. Certainly there are circumstances where this is not the case. Everyone seems prepared to concede that the tax should not apply where a child predeceases the parent so that the only possible donee or legatee would be a grandchild, although inexplicably, after much discussion about the issue, neither H.R. 6260 nor H.R. 6261 provides for such an exemption. What, however, of the child who is institutionalized, or alcoholic? In such cases there might be no logical alternative to passing property directly to grandchildren. Hence this assumption that the "natural" way of giving from generation to generation is first to give property to a child and then to have the child pass property on to his children has by no means been determined to be correct.

Taxing a direct skip is a step toward imposing a transfer tax at every generation. In the material given to the professional groups along with the proposed legislation on September 19th, it was pointed out that neither H.R. 6260 nor H.R. 6261 result in taxing wealth at every generation level, and posed the question of whether or not that was an appropriate goal. The College believes that it is not. Why should it be assumed that a tax should be imposed every generation? Why not every second or third generation? It had never before been suggested that there is a significant gap in this regard presented by the present provisions of Chapters 11 or 12. If in fact a tax is to be imposed at every generation level, should there not be resurrection of

the exemption or credit, whichever approach is used, at each generation level? The imposition of any generation-skipping tax plus, must, as stated before, be able to be understood by the average practitioner, must not be overly intrusive on a trustee's duties, and must be administrable by the Internal Revenue Service. To impose a tax at every generation level moves in the wrong direction in all three respects.

If the rationale behind taxing direct generation-skipping transfers is that wealth should be taxed in each generation even though a generation doesn't enjoy that wealth, why then should there be any tax at all imposed upon lateral transfers from a brother to a sister, or upon ascending transfers from a child to a parent? A logical concomitant to the adoption of a tax on direct generation skipping transfers is the adoption of a system which provides for credits against tax or even refunds in such cases. Does Congress really want to further complicate the existing transfer tax laws in this way?

Much has been or will be said about "layering". This is a much talked about, but probably seldom used, plan for persons of great wealth who are able to make separate provisions for children and grandchildren, and perhaps even great-grandchildren, without giving one generation benefits from property which passes to another generation. To do this requires enough wealth so that, for example, children will not suffer in order to benefit grandchildren.

As with the basic generation skipping tax, rates are a problem. A rate equal to 80 percent of the highest marginal rate, as adopted in H.R. 6260, assumes that the child "transferor" is in close to the top transfer tax bracket. This only would be true if the child has property in excess of \$1,500,000. It is patently nonsensical to assume that in every case that a taxpayer makes a direct transfer to a grandchild, the intervening generation has assets of that magnitude.

There is always the chance that a younger donee will die well before his life expectancy would otherwise indicate and hence the transferred property would again be subject to the transfer tax system through an estate tax on the grandchild's estate. If death occurs within a relatively short period of the date of the original transfer, the grandchild would have had virtually no time to enjoy the transferred property; the possibility of that happening should be recognized through a higher exemption or a lower tax rate. Another argument for taxing direct generation skipping transfers in a preferential manner (if they are to be taxed at all) is that a conscious decision has been made by the transferor to forego giving benefits to an intervening generation; there should be some recognition of this deprivation through lower rates or a higher exemption.

One should examine the philosophical implications of this new tax. Let us assume that most people amass enough wealth to make significant gifts no earlier than the time they are 60 years of age or at death. Since grandparents tend to die in their 70's or 80's, grandchildren would be in most cases between the ages of 25 and 35. It is at these ages that persons are likely to be at their highest entrepreneurial level and to make the best economic use of funds received by them. However, the transfer tax system as it has developed in recent years seems designed to operate to keep wealth away from such people of entrepreneurial age. Such measures as the unlimited marital deduction, the unified tax and the qualified terminable interest property trust work against the transfer of capital to people while they are of an age to use it constructively. Should there be yet another impediment to the transfer of wealth to people who might use it within our economy to create more wealth not only for themselves but for the country?

Taxation of direct generation-skipping transfers will encourage concentration of family wealth in the hands of children, rather than younger generations, since taxpayers will naturally opt to pass property free of this additional tax. One could argue that the encouragement of such a policy is inappropriate, or more forcefully stated, is against public interest.

Perhaps direct generation-skipping transfers should be preferred rather than discriminated against by granting them an additional exemption or by reducing the rate of generation skipping tax payable on such transfers. Alternatively, perhaps direct outright generation-skipping transfers should be preferred to generation-skipping transfers in long-lasting trusts.

The tax on direct generation-skipping transfers, either outright or in trust, occurs at the time of transfer under H.R. 6260. In all other taxable situations covered by H.R. 6260, the tax is paid when a distribution or termination occurs, not when the transfer is made. If there is to be a tax on direct transfers, the tax should not be payable until a taxable distribution or termination, rather than upon the transfer. This obviously would not work with respect to outright transfers; for those the tax would have to be paid at the time of transfer. However, for transfers in trust, the tax should be deferred until the time of taxable distribution or termination. If such

a change if not made, direct generation skipping transfers will be disfavored vis-a-vis other generation-skipping transfers.

7. Tax "exclusive" versus tax "inclusive"?—H.R. 6260 applies the generation-skipping tax on all but direct transfers on a tax "inclusive" as opposed to a tax "exclusive" basis. H.R. 6261 adopts a tax "exclusive" approach for direct skips and taxable distributions, but not for taxable terminations. It is the College's position that the tax, when applicable, should be imposed on a tax "exclusive," as opposed to a tax "inclusive," basis, although there is some logic for using the tax "inclusive" approach for taxable terminations, as opposed to taxable distributions.

The current gift tax is computed on a tax "exclusive" basis; the amount of the tax is not included in the amount of the transfer subject to gift tax. On the other hand, the estate tax is computed on a tax "inclusive" basis in that the estate tax may not be deducted from the gross estate in computing the estate tax. The College submits that a taxable distribution (which occurs when a beneficiary attains a particular age, or distributions are made on a discretionary basis) is much more in the nature of a gift than a legacy. To be consistent with current transfer tax law, the tax should be applied to such distributions on an exclusive, as opposed to an inclusive, basis. H.R. 6261 takes this approach and in this respect is preferable to H.R. 6260.

If the tax on such distributions is applied on an inclusive basis, the overall rate of total transfer tax, considering both gift and generation skipping tax, is entirely too high. The examples set forth immediately below amply demonstrate this. Having the transfer taxable on an exclusive, rather than an inclusive, basis not only would be consistent with the current transfer tax law but it would reduce the overall rate of tax on such gift-type transfers to a more appropriate rate. The College would have no objection to applying the tax in each instance (even taxable terminations) on a tax exclusive, rather than tax inclusive, basis if this was desired for consistency or simplicity. It is true that H.R. 6260 taxes direct transfers on an exclusive, rather than an inclusive, basis but for reasons set forth immediately above, the College feels it is entirely inappropriate to tax direct transfers in any fashion. The following examples and computations will show the consequences and the combined maximum rates of using a tax inclusive as opposed to a tax exclusive approach. They are based on the 80 percent of maximum transfer tax rates contained in H.R. 6260.

In the case of a direct generation skipping transfer by lifetime gift, a donor may transfer \$44.80 to his grandchild at a total tax cost of \$55.20, so that the total tax rate on the \$100.00 depletion of the donor's estate would be 55.2 percent. This is arrived at by a total of 44 percent of the gift for generation-skipping tax purposes, plus 55 percent of the gift (the amount of which under both H.R. 6260 and H.R. 6261 must be increased by the generation-skipping tax) for gift tax purposes, both computed on a tax exclusive basis. The effective rate of tax on the net transfer is well over 100 percent.

If the direct transfer is made at death, then the tax will be tax inclusive so far as the estate tax is concerned, but not so far as the generation skipping tax is concerned. Thus, the same \$100.00 will result in the grandchild receiving \$31.25 in the case of a direct generation skipping bequest. This is because the \$100.00 will be subject to \$55.00 of estate tax and a generation skipping tax of \$13.75, being 44 percent of \$31.25. Thus, here the tax has been increased to 68.75 percent of the gross amount. However, the effective rate of tax on the net amount transferred is in excess of 200 percent! This is so because it takes a tax of \$68.75 to transfer \$31.25.

In the case of a taxable distribution from an inter vivos trust, the tax becomes an aggregate of 63.9 percent. A transfer of \$64.50 to the trust would cost approximately \$35.50 in gift tax. The generation skipping tax would be 49 percent of \$64.50, or \$28.40, making the total tax \$63.90 and leaving \$36.10 for the grandchild. Again, we see the need to transfer close to twice as many dollars to the government as pass to the donee.

In the case of a taxable distribution from a testamentary trust, the tax becomes an aggregate of 74.8%. The original \$100.00 is reduced by 55% estate tax and the remaining \$45.000 is taxed at 44% or a total of \$19.80, which when added to the \$55.00 arrives at 74.8%. Here the effective rate on the net transfer is just under 300%.

The same result will occur in the case of a taxable termination since there is no reduction for the generation skipping tax.

It should be noted that the tax inclusive rates, combining both estate tax and generation skipping tax, are only some 5% less than if property was left to the child and included in the estate of the child for future disposition to the grandchild. In such a case, the estate of the child is increased by \$45.00 and the tax at the child's

death would be \$24.75, assuming that both the original testator and child are in the top bracket. Thus, the combined tax would be \$79.75.

Estates over \$1,500,000 are subject to a 44% transfer tax rate. Hence anyone with an estate smaller than that is adversely affected by the use of 80% (much less the 100% approach taken by H.R. 6261) of the highest marginal transfer tax rate as the generation skipping tax rate. Moving to a tax exclusive system would result in a better (although not completely appropriate) matching of tax treatment regardless of whether a parent transfers to child and child transfers that same property on to grandchild with an estate tax paid at that time, or whether a generation-skipping tax is paid where the child is treated as the "deemed transferor".

8. *The income exception.*—Unlike present Chapter 13, the Treasury proposal does not except income distributions from the generation-skipping tax. The College urges retention of the income exception for two reasons. The first is that the presence of such an exemption will simplify administration of, and compliance with, the law. A trustee would not have to be concerned with filing a generation-skipping tax return, and paying a tax, when only distributions of income were made to a beneficiary during a particular year. In a great number of trusts, modest amounts of income are paid out currently to beneficiaries for current consumption; these distributions are rarely accompanied by invasions of principal. The College submits that since the aim of the generation-skipping tax is to discourage tax-free transfers of great wealth to lower generations, application of the tax to periodic distributions of only income is not warranted. The second reason for the College's opposition to taxing income distributions is that the effective rate of tax on such distributions of income, considering income, gift taxes paid on the original contribution to the trust, and generation-skipping tax, is well in excess of the current maximum estate and gift tax rates. While a deduction is granted against income for generation-skipping tax paid, the overall rate of tax is at the minimum 72%. For example, if a \$100 income distribution subject to the generation-skipping tax was made, H.R. 6260 would impose a generation-skipping tax of \$44. This would constitute a deduction from the \$100 of income, leaving \$56 subject to income tax; if the recipient was in the 50% bracket, the tax would be \$28.00. This \$28 income tax combined with the \$44 generation-skipping tax amounts to a \$72 tax on the \$100 income distribution. Again we see a tax (72%) far in excess of the 50% maximum income tax rates.

9. *Comments on miscellaneous matters.*—The ALI proposal does not contain generational assignments for persons who are not family members of the grantor. Thus, if a grantor were to create a trust to sprinkle income and principal among his or her best friend and that friend's children, with remainder going to the friend's children upon the death of the friend, there would be taxable distributions and terminations even though the friend is older than the grantor and the friend's children were the same age as the grantor's children. There is no way that this could be conceived of a generation-skipping arrangement. Nonetheless, it would be subject to the tax.

Probably both the Treasury and the ALI proposal fall short in the area of charitable split interest trusts. For example, if a charitable remainder trust were created for a family friend or retainer, that person would not be given a generational assignment no matter what his or her age, and any distribution of the unitrust or annuity amount would be a taxable distribution. The ALI proposal requires that the tax be paid by the trustee unless the distributee consents to be liable for the tax. The rules governing charitable remainder trusts (and which must be adhered to in order to receive income, gift and estate tax deductions) require that there be a fixed percentage of either the initial fair market value of the trust, or the value as determined from year to year, paid to the beneficiary. Is there compliance with these rules when the distribution is subject to the payment of the GST by the beneficiary? Arguably not, since the annuity or unitrust amount will be reduced by such taxes. Moreover, assume that the tax is paid by the trustee. Does this not mean that there would be a reduction in the value, or even the elimination, of the charitable deduction for the remainder interest? It would appear essential that changes would have to be made in Section 664 to accommodate these possibilities.

10. *Effective date.*—The College supports the retroactive repeal of Chapter 13 and the effective date provisions for the new legislation as set forth in the latest draft of the Treasury proposal dated February 2, 1984. It would be unfair and inappropriate to retroactively subject any pre-existing trust to the provisions of any new law.

11. *Conclusion.*—The College wants to help in resolving the enormous problems caused by the continuing application of Chapter 13. Repeal of the present statute is clearly called for. Without taking a position on whether there is to be an alternative, the College views with favor the general approach taken by H.R. 6260 rather than H.R. 6261 but believes certain modifications to that proposal as set forth above, viz, increases in exemptions and reductions in rates, elimination of tax on direct

generation-skipping transfers, adoption of a tax "exclusive" rather than a tax "inclusive" approach, and retention of the income exception, are essential to meet the objectives of limited scope and relative simplicity for any alternative tax to present Chapter 13.

EXHIBIT A

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Mr. ANTHONY. Thank you, Mr. Moore.
Mr. Nebenzahl.

**STATEMENT OF BERNARD W. NEBENZAHL, CHAIRMAN-ELECT,
ESTATE PLANNING SUBCOMMITTEE, FEDERAL TAX DIVISION,
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

Mr. NEBENZAHL. I am Bernard Nebenzahl, and I am the incoming chairman of the Estate Planning Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants.

Since 1974, we have supported the concept of generation-skipping. At the hearings on the 1976 act, we testified in favor of it. Since enactment, however, our views have changed. The complexity, the difficulty of administration, lack of equity, lack of revenue from the generation-skipping transfer tax, have all been well-documented.

The question is whether the tax should be modified or repealed. Our view is that it should be repealed.

Current chapter 13 provides a very complex statutory scheme. The Treasury has expended tremendous efforts in developing regulations for the law. Taxpayers and their advisers have expended great efforts in trying to understand the law and regulations. All agree today that they do not work.

It can be circumvented by taxpayers with sophisticated tax advice, and it is just as likely to trap the unsophisticated taxpayer. Tax-saving opportunities should not be available only to those with the motivation and means to take advantage of them, and those that wish to comply with the law should not be required to incur heavy expenditures for professional advice. To continue this unworkable part of the code we feel is bad tax policy.

While we have not had sufficient time to completely review the current proposals, we would like to make the following comments. The proposed legislation seeks to avoid the generation-skipping tax on the moderately wealthy families by providing a credit or exemption. The Treasury proposal states that the tax is geared to hit the wealthiest taxpayers. But the modest amount of exemption or credit is not enough to prevent it from having a substantial effect on those of more modest wealth.

It continues the complexity in situations where families may not have sophisticated tax advice available to them, thus creating traps for the unwary. It can create hardships where a family business or a family farm is being transferred to a lower generation because of the death of the intervening generation, or because of a situation where they may not want to have the intervening generation control the property.

On the other hand, increasing the exemption will not reduce the complexity to those affected, and we do not believe the tax system

should be more onerous in rules for those with means simply because they are able to pay for the advice to comply.

By taxing direct transfers, the proposed legislation makes a dramatic change in tax policy. Direct transfers to family members should not be inhibited. We believe that such transfers are not abusive and we feel that they should not be subject to the added tax. The proposals do not even make an exemption for direct transfers where the intervening generation has died. Under the proposals, direct transfers are taxed at the same rate as indirect transfers.

We also question the tax every 35 years on nonowned trusts in the American Law Institute's proposal. This seems to be an arbitrary cutoff when a person's life expectancy is substantially greater. In addition, any tax such as the one proposed should provide for installment payment of taxes related to the transfer of a closely held business, credits for tax on prior transfers, and a statute of limitations on questions of value.

We realize that this is an important area of perceived inequity and possible abuse, but we feel that to add the amount of complexity that must be added to the law in order to deal with the small segment of taxpayers involved is a bad precedent for tax policy.

We urge you to repeal the current generation-skipping transfer tax now. It is unfair to taxpayers and their advisers to keep them in suspended animation until all alternatives are explored. In fairness, we believe the tax should be repealed retroactively.

We appreciate the opportunity to present our views. We expect to continue to study this area and comment further on legislative proposals.

Thank you.

[The prepared statement follows:]

STATEMENT OF BERNARD W. NEBENZAHL, CHAIRMAN-ELECT, ESTATE PLANNING SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Good morning. My name is Bernard Nebenzahl, and I am the incoming chairman of the Estate Planning Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants. I am speaking on behalf of the AICPA and its approximately 20,000 members, many of whom have had to or will have to deal with the very complex generations skipping transfer tax which is the subject of today's hearings.

The AICPA supported the enactment of the generation skipping transfer tax in 1976. Our Tax Policy Statement Number 4 on Estate and Gift Tax Reform, approved in 1974, supported the concept of a generation skipping transfer tax, and at hearings on the Tax Reform Act of 1976, the AICPA testified in favor of such a tax where the skipped generation nevertheless received a benefit. Since enactment, however, our views have changed because of practical problems in applying the law and because subsequent changes in transfer taxes generally have eliminated the need for such a tax.

The complexity, difficulty of administration, lack of equity, and lack of revenue from the generation skipping transfer tax have now been well documented. Even the Treasury, which is the main proponent of the tax, is calling for it to be significantly modified. The question is whether this tax should be modified and given another chance or should be repealed. Our view is that the tax should be repealed because, even with corrections, the slight increase in perceived equity is not worth the accompanying complexity in our tax law.

The generation skipping transfer tax was enacted to prevent the avoidance of estate and gift taxes by transferring assets beyond the next generation, while providing for the next generation through use of trusts. These trusts could provide the children with income during their lives, and access to the trust principal in limited situations. In order to avoid the tax at the child's generation, however, substantial

interests would have to bypass him or her and go directly to the grandchild. Such a plan would not generally coincide with the disposition wishes of most individuals. In most cases, the real deterrent to generation skipping is the natural desire of the transferor to provide for the children he or she has raised, rather than for grandchildren whose abilities and values may not be well known by the transferor.

Current Chapter 13 provides a complex statutory scheme to deal with generation skipping. Great efforts have been expended by the Treasury in developing regulations. Taxpayers and their advisors have expended great efforts in trying to understand the law and regulations, and all agree that it does not work. It can be circumvented by the taxpayer with sophisticated tax advice, and it is just as likely to trap an unsophisticated taxpayer who has tried to take care of a non-tax estate planning problem. Tax saving opportunities should not be available only to those with the motivation and means to take advantage of them, and those who wish to comply with the law not be required to incur heavy expenditures for professional advice. To continue this unworkable part of the Code is bad tax policy, and Chapter 13 should be repealed immediately.

While we have not had sufficient time to completely review the current proposals, we would like to make the following comments. The proposed legislation seeks to avoid the generation skipping tax on the "moderately" wealthy families by providing a credit or exemption. The Treasury proposal states that the tax is geared to hit the wealthiest taxpayers. But the modest amount of exemption or credit is not enough to prevent it from having a substantial effect on those of more modest wealth. It continues the complexity in situations where families may not have sophisticated tax advice available to them, thus creating traps for the unwary. It can create hardships where a family business or a family farm is being transferred to a lower generation because of the death of the intervening generation.

On the other hand, by increasing the exemption to reduce the number of taxpayers effected, it will not reduce the complexity for those who are. We do not believe that the tax system should have more onerous rules for those of means merely because they are more able to pay for professional advice to comply.

By taxing direct transfers, the proposed legislation makes a dramatic change in tax policy. Direct transfers to family members should not be inhibited. We believe that such transfers are not abusive and we feel that they should not be subject to the added tax. The proposals do not even make an exemption for direct transfers where the intervening generation has died. Under the proposals, direct transfers are taxed at the same rate as indirect transfers. If the Treasury proposal were adopted, this would favor indirect transfers. They are taxed once and may last three or more generations, while the direct transfer will be taxed on the death of the recipient. This would favor the super-wealthy who can afford and are more likely to make indirect transfers.

We also question the tax every 35 years on "non-owned" trusts in the American Law Institute's proposal. This seems to be an arbitrary cutoff when a person's life expectancy is substantially greater. In addition, any tax such as the one proposed should provide for installment payment of taxes related to the transfer of a closely held business, credits for tax on prior transfers, and a statute of limitations on questions of value where a credit is used in payment of the tax.

We realize that this is an important area of perceived inequity and possible abuse, but we feel that to add the amount of complexity that must be added to the law in order to deal with the small segment of taxpayers involved is a bad precedent for tax policy. We urge you to repeal the current generation skipping transfer tax now. We understand the reluctance to do so until other possible alternatives are explored, but we do not believe a fair and equitable solution will be quickly found. It is unfair to taxpayers and their advisors to keep them in suspended animation until all alternatives are explored. In fairness, we believe the tax should be repealed retroactively.

We have not had sufficient time to completely review the proposals that have been presented. But, as indicated earlier from our brief review, we believe that the level of exemption or credit should be such that the tax not apply to the moderately wealthy and that there should be no tax on direct transfers which truly skip a generation.

We appreciate the opportunity to present our views. We expect to continue to study this area and comment further on legislative proposals.

Mr. ANTHONY. Thank you very much.

Is there anybody on the panel who does not favor immediate outright repeal?

What do you think would be the immediate impact if there was an immediate repeal of chapter 13?

Mr. Lewis.

Mr. LEWIS. If you are asking for my individual views, I think that, considering the Treasury's attitude at this point, the more realistic alternative before us is that of repeal joined with the enactment of a substitute.

Mr. ANTHONY. That would be your personal position?

Mr. LEWIS. That would be my personal view, yes.

Mr. ANTHONY. Repeal with immediate replacement?

Mr. LEWIS. Yes.

Mr. BRUCE. I would say that that would be perhaps possible if you are going to be able to construct a replacement in a short period of time. But we have lived with this law for 8 years; it is causing practitioners a great deal of difficulty. And Mr. Zissman testified to the problems the bankers have. I think it should be got off the books as quickly as possible.

It does not mean that the collegial process cannot be ongoing to try to forge a new law. But I think we should be getting rid of the present law as soon as possible.

Mr. ANTHONY. Do you see any problem in waiting 12 months in an effort to try to get all parties together?

Mr. BRUCE. From my section, we will cooperate—that is, the official American Bar Association policy. And we in the tax section would cooperate with Treasury and congressional staff in attempting to work on a new bill. But we would like to see the present law gone.

Mr. ANTHONY. Mr. Zissman.

Mr. ZISSMAN. My personal view is that it would be an act of patriotism to repeal it and stop there. I have the impression that that is not real life. That isn't what is going to happen. That is why the American Bankers Association has endorsed the approach in the Treasury proposal. If that happens—that is, if what you suggest were to happen, a repeal today and a substitute statute a year from now—of course, it is possible that lots of people would jump in and create irrevocable trusts that would be designed to avoid the old tax that would be repealed and would avoid the new tax that they felt was coming down the line.

Of course, they would not be able to do that with certainty if there were a kind of in terrorem clause in the repeal or in the legislative history, very much like the chairman's in terrorem clause in announcement of this meeting, which could suggest the possibility that there could be retroactive application back to some date unknown at the same time. So I think it would be possible for you to choose to repeal the statute today and come up with a replacement at some point in the future.

Mr. ANTHONY. Pretty much like Garn-St Germain did on the nonbank banks.

Mr. ZISSMAN. OK.

Mr. MOORE. I would echo what Mr. Bruce and Mr. Zissman said. But I, as a practicing lawyer in this for 8 years—my clients have had to live with it; they get tired of me talking about a law that will not be on the books but that they have to comply with. But

there are questions about Treasury Department, frankly—noncompliance.

We have a law honored in breach in large parts of the country, and I don't think that is good for the voluntary taxpaying system. That is why it would be an act of patriotism to repeal it, as Marshall said. We have heard that we will have substitutes, and yet they—nothing ever seems to be done in this area. We have been 8 years down the road now and still in the quagmire.

I think it is essential that the statute be gotten off the books and that we, along with the others, will certainly give constructive help to an alternative if that is deemed to be the proper approach, perhaps with some kind of, as Marshall said, in terrorem clause in the meantime, so you don't have the fear that people will go out and make huge transfers before it is too late, which is a fear that some people may have.

Mr. NEBENZAHL. I feel it should be repealed now, if a transfer is subject to the current tax, we, as practitioners, are in a dilemma. Do we struggle to understand the law and file a tax return, or do we advise our client to delay and hope the law will be repealed? If a tax is paid under chapter 13 now, will it be subject to an automatic refund if the law is repealed?

To go on with this uncertainty creates a tremendous problem for me as a practitioner in how I should advise my client. Yes, if you repeal the law now without a new one to replace it, some people may go out and create a generation-skipping trust. But generally, estate planning for people with large estates usually takes a long period of time. They do not arbitrarily create irrevocable trusts with large sums of money tied up for a long period of time. I do not believe that there will be a wholesale rush to set up generation-skipping trusts.

Further, while people will set up generation-skipping trusts, the period of time in which they may do it will not be long if action is taken quickly to enact the new law. If there is the desire to have the generation-skipping tax, as demonstrated by the attention that has been given to it, then if the old law is repealed, there will be sufficient impetus to get a new one on the books before the gates of avoidance have been open too long. To leave a statute on the books, which everyone agrees should be repealed, as a club to get people to work to get a new law is bad tax policy.

Mr. ANTHONY. I want to thank you very much.

Mr. Russo.

Mr. Russo [presiding]. Thank you.

I thank the panel.

Our next panel will be: The Illinois State Bar Association, Tim Baetz; Chicago Bar Association, Howard McCue; New York State Bar Association, Ira Lustgarten; and New York State Bar Association, Henry Christensen III.

Mr. Baetz, welcome to the committee. As a member of the Illinois State Bar Association myself, I am pleased to see a member of the bar here and look forward to your testimony.

If you can, as the other panel did, try to summarize in 5 minutes so we can get to the questions on this interesting subject of generation-skipping transfers.

**STATEMENT OF W. TIMOTHY BAETZ, SECTION ON FEDERAL
TAXATION, ILLINOIS STATE BAR ASSOCIATION**

Mr. BAETZ. Thank you, Mr. Russo.

It is a less interesting subject after you have wrestled with it 8 years.

Mr. RUSSO. I understand.

Mr. BAETZ. My name is Baetz. I am here on behalf of the Illinois State Bar Association's 26,000 members. I am a member of that association's tax section council. Over the last 8 years, I have served from time to time on the American Bar's, Illinois State Bar's, and Chicago Bar's Committees on Generation-Skipping Tax.

The Illinois State Bar Association was perhaps the first professional organization in America to recognize that the current chapter 13 is unworkable. Many years ago, we called for repeal. This morning, I have heard no one speak a kind word about the current chapter 13, and I gather there is now universal agreement that that statute must be gotten rid of as quickly as possible.

I am fascinated at the linkage between the death of the current chapter 13 and any substitute tax. Frankly, Congress had the opportunity at the time of the last tax bill—if not to repeal the tax, if it was deemed more politically acceptable to hold it simply in abeyance, to do that. Moratorium language had been proposed in prior sessions of Congress. The Illinois State Bar Association once again begs that the current tax go away quickly.

Now, as to what to do instead, I must say I am frankly quite confused at this point. I have reviewed four Treasury proposals, the latest of which is H.R. 6260. I have reviewed an ALI statute recently released. And I have read the ALI discussion draft. I am mindful that the ALI has not taken any formal action in the matter, and on at least one very controversial point—the direct skip—the Tax Consultant Group was one vote away from a complete deadlock on the subject.

I also notice that other witnesses today are prepared to discuss other alternatives which, frankly, I think, are fairly ingenious. One has to do with a so-called nonmarital deduction; and another has to do with what I think of as a sort of stepsister to an accessions tax. All of this tells me that we are swimming around trying to find out what is really broken, so that we can really help you fix it.

I think with Treasury's recent proposal, particularly in its direct-skip aspect, we become more confused than ever, because, frankly, however it may masquerade as a transfer tax, it is legitimate I think to conceive the direct skip tax as in the nature of a capital levy, and it calls into question the whole framework for the existing tax, in my view.

What stuck in Congress craw in 1976? From discussions with the chairman of this committee, I got the distinct impression what bothered Congress was that people had the capacity by resort to trusts to put property outside the purview of the existing gift and estate tax systems arguably for as much as 150 years. Frankly, that sticks in my craw, too.

The solution went way beyond the evil, in my judgment. It was natural, I suppose, for people to begin to focus on generations because inexorably over long periods of time property ownership has

to move in a generational sense down—not up. But the real issue, I always thought, had nothing to do with generations, their expiration, the nature of powerholders and interest holders within the generations. It had to do with a glitch, a place where the estate and gift taxes did not apply where Congress believed they should.

Now, I would submit to you that among the things that ought to be considered at this moment is an abandonment of this idea of generations altogether. First, finding beneficiaries, figuring who they are—it is a problem. Treasury now thinks powerholders shouldn't be classed as beneficiaries.

Second, assigning beneficiaries to generations continues to baffle people, particularly when you get outside the borderline of family. Let's try in a collegial way to figure out what is broken. And the Illinois State Bar Association thinks it would be appropriate to have a commission that could find out from all of you what is really on your minds. In the meantime, put a moratorium on the current law.

One last word about direct skips. I think you will hear a lot of adverse commentary today. The addition of the direct-skip concept is intellectually appealing. But, practically speaking, it will be offensive to many. I think it is up to you to tell us whether the concept has any real merit. Do we really have to tax when someone doesn't give anything to anybody?

Thank you.

[The prepared statement follows:]

STATEMENT OF W. TIMOTHY BAETZ, ILLINOIS STATE BAR ASSOCIATION

Mr. Chairman and members of the Committee, my name is W. Timothy Baetz, and I am here on behalf of the Illinois State Bar Association, a professional organization comprised of 26,000 attorney members. I serve on the Council of the Association's Section on Federal Taxation, and I am a partner in the Chicago law firm of McDermott, Will & Emery.

Until 1983, I served as Chairman of the Generation-Skipping Tax Subcommittee of the Committee on Estate and Gift Taxes of the Section of Taxation of the American Bar Association. I was principally responsible for all comments filed by the American Bar Association with respect to regulations proposed under the current federal tax on certain generation-skipping transfers. I was also a principal author of the American Bar Association's response to the Treasury Department's first proposal to revise Chapter 13.

On behalf of various bar associations, I have testified at three U.S. Senate hearings on generation-skipping tax problems and have participated at countless meetings with representatives of the Treasury Department and other government officials to discuss generation-skipping tax issues. I have published three articles with Chapter 13 and have lectured on the subject many times at lawyer seminars across the country.

After all this activity in connection with generation-skipping tax affairs, I still am not certain exactly what the generation-skipping tax abuse is. Indeed, I am less certain now than ever before and this by reason of H.R. 6260 and H.R. 6261, the reform bills you recently introduced. These bills contain new approaches to the generation-skipping tax issue that merit very careful consideration and full debate. I know that it is the intention of this Committee to see that such consideration and debate occur, and I am grateful for this opportunity to participate in the process.

THE ASSOCIATION'S POSITION

Long ago, the Illinois State Bar Association adopted a resolution calling for the immediate and complete repeal of Chapter 13 and related Internal Revenue Code provisions. The reasons for the Association's position were conveyed verbally and in writing at the June 5, 1981, November 4, 1981, and June 27, 1983, Senate hearings on this subject and need not be reiterated here.

Now, new proposals in the form of H.R. 6260 and H.R. 6261 appear as "solutions" to the generation-skipping tax "problem." I received copies of these proposals from your Committee's office eight days ago. In a number of respects, the new proposals differ from prior Treasury reform proposals, and, of course, the two proposals differ from each other. Each proposal is lengthy and complicated. The current Chapter 13 consists of nine Internal Revenue Code sections; H.R. 6260 (the "Treasury proposal") consists of twenty-two such sections and H.R. 6161 (the "ALI proposal") consists of twenty-one such sections.

In the eight years that the current Chapter 13 has been the law of the land, new problems and questions have bubbled up constantly through the complexity of the statute to befuddle and bedevil taxpayers and government alike. It is unlikely that in the eight days since I received H.R. 6260 and H.R. 6261 from your Committee's office even a small fraction of the problems and questions arising out of these proposals has surfaced and been properly analyzed by those of us who are here today.

In the following remarks, I will try to address some of the issues which I believe are raised by the two bills, and I know that other witnesses will do likewise. But I am hard pressed to believe that the proper analysis of these bills and other worthwhile proposals can be completed for quite some time. Furthermore, as is explained more fully below, I believe that it is important for Congress to articulate with greater precision just what it intends to accomplish by a generation-skipping tax before a proper piece of legislation can be forged, behind which all of us can stand supportively and with confidence.

In view of the foregoing, the Illinois State Bar Association asks this Committee to consider doing two things:

1. *Empanel a commission.*—The commission's task would be to articulate with precision the true generation-skipping abuse at which legislation ought to be directed and to select the best means legislatively to correct that abuse. The commission would be comprised of government and private-sector "experts" on the subject.

2. *Place a moratorium on the current Chapter 13.*—The existing tax on certain generation-skipping transfers is acknowledged to be unworkable (even by the Treasury Department) and yet continues to confound the estate planning process. That process should be allowed to be conducted without reference to the current Chapter 13 until the generation-skipping tax issue has been resolved. A proper form of moratorium was introduced but not enacted as part of ERTA '81.

THE TROUBLE WITH "DIRECT-SKIPS"

When Chapter 13 was enacted in 1976, many of us thought that Congress' principal concern was with the use of trusts to hold property outside the federal estate and gift tax system for long periods of time. The fact that a long-term trust normally benefited individuals in generations younger than that of the trust's creator may have led many naturally to conceive the problem in terms of generation assignment, but it always seemed to me at least that what really stuck in Congress' craw was that individuals, as trust beneficiaries, could enjoy various benefits of economic significance under a long-term trust without that trust's corpus being subject to federal transfer tax for one hundred years or more.

Now, H.R. 6260 and H.R. 6261 advance the proposition that a tax is appropriate even when a transfer of property does not suspend that property outside the purview of the federal estate and gift tax for a single moment. In fact, the tax is deemed "essential to the integrity of the federal transfer tax system" even when a transfer has nothing to do with a trust, as when a grandparent gives property directly to his grandchild.

This tax, sometimes called the tax on direct-skips, represents a dramatic departure from traditional concepts of transfer taxation. It is a tax imposed because the transferor did not transfer anything to someone, rather than because the transferor did transfer something to someone or for someone's benefit. It is a tax that calls into question just what Congress thinks is the root problem that justifies transfer taxation in the Chapter 13 context.

The Treasury Department defends the direct-skip tax as the means to prevent "layering." But, perhaps that justification misses the mark. First, the property involved in a direct-skip transfer is always subject to the gift and estate taxes. For over fifty years, such estate and gift taxation has been deemed adequate. Why all of a sudden in the name of equity is double transfer taxation deemed essential in such circumstances? Second, the direct-skip in trust is taxed only at the beginning, albeit twice, even if thereafter several younger generations of trust beneficiaries share in the enjoyment of trust income and corpus, in ways that under current law breed several generation-skipping transfers. Will this not lead to resort to very long-term

trusts, rendering our tax laws anything but neutral in the trust context? Third, the direct-skip tax is imposed up-front on top of the estate or gift tax that also applies. Is this the sort of rhythmic, once every so often, transfer tax system that Congress said it was trying to protect when it enacted Chapter 13 in 1976?

If the real evil is holding property outside the estate and gift tax system for long periods of time, the direct-skip tax is not the answer. Indeed, as discussed more fully below, even the focus on generations may be erroneous if the evil is suspension of property beyond gift and estate taxation. If removing property from the application of gift and estate taxes is what Congress wants to stop, the simple answer lies in a feature of the British tax system—a capital levy every forty or fifty years.

CAPITAL FORMATION AND FRONT-LOADING THE TAX

The direct-skip tax contained in both the Treasury and the ALI proposals is assessed up-front, right now and on top of an estate or gift tax. In addition, other features of both new proposals tend to accelerate the imposition of tax as compared to the current Chapter 13, tend to make the tax payable sooner rather than later.

No one has yet commented upon the potentially adverse effect on capital formation such acceleration would produce. Is more transfer tax sooner consistent with Congress' purpose to foster capital formulation, a purpose reflected repeatedly in tax laws enacted during the past three years? Before committing to such taxation, we believe that Congress ought to consider the effect on family farms and closely held businesses.

GENERATION ASSIGNMENT

Both H.R. 6260 and H.R. 6261 require generation assignment. Generation assignment can be tricky business, especially in the context of entity-beneficiaries. See Baetz, "The Generation-Skipping Tax: A critique of Proposed Regulations Regarding Definitions and Special Rules," 6 *Notre dame Est. Plan. Instit.* 487-495 (1982).

The argument is suggested above that the real purpose of Chapter 13 need have nothing to do with generation assignment or, for that matter, with identifying beneficiaries. The direct-skip proposal forces re-examination of the purposes behind the Chapter 13 tax, and we would suggest that it is quite possible that such re-examination may lead to the conclusion that generation assignment is not necessary as part of a proper tax. If generation assignment were unnecessary, one of the continuing Chapter 13 problems would be eliminated. In fairness, it should be pointed out that generation assignment is a simpler matter under ALI's proposal than under Treasury's proposal.

It is relevant in this context to note that the Treasury bill veers away from the generation-by-generation taxation to which Congress made reference in the committee reports underpinning the original Chapter 13. Now, once a taxable termination occurs, no further taxation is sought as the interests of younger generation beneficiaries expire. This calls back into question just what purpose the generation-skipping tax is intended to serve.

AMOUNT OF TAX SHELTER

Both H.R. 6260 and 6261 provide hefty tax shelters. Presumably, the intent is to leave the generation-skipping tax on the backs only of the very wealthy. But if it is unclear that worthy policy purposes are being served, is the tax not just as suspect if applied to fewer taxpayers?

Moreover, a few points must be borne in mind when fixing the amount of the shelter. First, I am a forty year old who smokes, and yet I can buy \$1,000,000 of term life insurance in today's market for less than \$1,000. I do not count myself as "wealthy," but I know that my life insurance will be taxed for estate and generation-skipping tax purposes. I also know that the government is encouraging a private-sector pension system by means of tax laws favoring qualified benefit plans and individual retirement accounts. The balances in such plans and accounts can become sizable if one is sufficiently frugal, and the balances remaining at death are subject to estate and generation-skipping taxation. In short, \$1,000,000 can be generated at death by lots of people who are not, during life, "wealthy."

Second, ALI expressed the view in its study on generation-skipping transfers that at a \$1,000,000 level of tax exemption: "Lawyers, among the most vociferous opponents of Chapter 13, would lose one of their major arguments—the one based on the inability of most practitioners to cope with the law." The ALI group is, unfortunately, mistaken. Clients who would be subject to tax under Treasury's proposal or ALI's proposal are apt to live anywhere and may rely on any practitioner. Thus, the

coping problem remains under both new proposals although, as discussed below, that problem will be present more often under the ALI proposal than under the Treasury proposal.

Third, big passes seldom last long. The original Chapter 13 started out with a \$1,000,000 grandchild exclusion, advanced by the government for reasons similar to those that now prompt the big tax shelters contained in the new Treasury and ALI proposals. As you know, the exclusion ended up being cut to \$250,000. Qualified benefit plan balances used to be exempt from federal estate taxation. That exemption was cut in 1981 to \$100,000 and then in 1984 to zero. It is easy to see why arguments in favor of H.R. 6260 and H.R. 6261 that are based upon the generous proportions of the tax shelter are viewed with a skeptical eye.

EXEMPTION OR CREDIT

The Treasury proposal would cast the Chapter 13 tax shelter as a \$1,000,000 exemption. The ALI proposal resorts instead to a \$417,000 tax credit. There are some problems with either approach.

The exemption is appealing because, if you are out at the beginning, you are out forever. But this aspect of the exemption is a two-edged sword because, when you are in, you cannot get out even when circumstances suggest merit in an extraction. The ALI study confirms that most people do not establish estate plans that involve generation-skipping, and when generation-skipping is involved, almost nine times out of ten only one generation is "skipped." The skipping often occurs because of a natural and understandable reluctance to give property outright to descendants at younger ages. Suppose, for example, a trust creator (who has no benefit of a deceased spouse's Chapter 13 exemption) creates a \$1,000,000 trust for each of his two children, providing that each child must reach age thirty to take free of trust with a gift over per stirpes to that child's descendants. Suppose further that the creator allocates his exemption half to each trust. One child lives to age thirty and takes outright; the other child dies at age twenty-nine and his or her children succeed to their deceased parent's share. The creator has wasted half of his exemption, and a Chapter 13 tax is due in circumstances where no tax would have been imposed if only the creator could have known what would happen. A similar result can obtain when a creator fails to make an allocation and IRC §2632(c)(1)(B) takes over to make the allocation for the creator.

Another weakness of the exemption has already been recognized. It operates to exempt from Chapter 13 all post-transfer appreciation. A \$1,000,000 trust growing at ten percent per annum for fifty years will exceed \$117,000,000 in value at the end of the term. That is a lot of value to let escape federal transfer taxation for over half a century.

The credit carries at least two disadvantages. First, in planning estates, Chapter 13 will have to be taken into account far more often than would be the case under an exemption regime. This is, of course, because the planner cannot predict during the planning process what property values will be at the time taxable events occur and the credit operates. Second, the credit mechanism requires far more record-keeping than the exemption, perhaps over very long periods of time, in order properly to track credit consumption. This involves additional trust administration expense even if one assumes, as may not be true, that the chore will be performed in most or all cases.

TRUST EQUIVALENTS

As regards the current Chapter 13, lots of critical commentary has been aimed at the concept of "trust equivalents" as defined in IRC §2611(d). See Baetz, *op. cit.*, at 495-511. It is interesting to note that, while both H.R. 6260 and H.R. 6261 abandon the "trust equivalent" as a defined term, each retains the concept in a form almost identical to that found in current law.

The fact is that the trust equivalent is an inherent problem in both proposed systems. It has to be there, but it also has to be, by its very nature, very difficult to handle. Fortunately, both bills exclude probate estates from the classification, but that still leaves plenty of problems that have never been solved under the existing Chapter 13.

NOMINAL INTERESTS AND SEPARATE SHARES

Nominal interests and separate shares are concepts that cause questions and concerns under the existing Chapter 13. See Baetz, *op. cit.*, at 543-550 (nominal interests) and at 578-587 (separate shares). Clearly, nominal interests continue as a part

of both new proposals. It is somewhat less clear that separate shares offer problems in the two new proposals, although it would seem they do. Both concepts present definitional difficulties that have never been solved under existing Chapter 13.

INTERACTION WITH THE INCOME TAX

The Treasury proposal offers IRC § 691 relief for taxable terminations and IRC § 164 relief for taxable distributions. The need for the difference in treatment is not readily apparent.

The ALI proposal seems to offer gift tax relief from income taxable "taxable distributions." It will be interesting to see at what rate that relief is set, the matter having not been resolved in the proposal.

OVERALL IMPRESSION

Without a doubt, both new proposals are vast improvements over the existing Chapter 13. But each raises important policy questions, particularly in the context of direct-skips. It is not possible wholeheartedly to support either proposal at this time.

Both proposals deserve further careful scrutiny. Each is novel and complex. As between the two, the ALI proposal appears at first blush to be easier to apply and the Treasury proposal appears to be the less intrusive in the estate planning process.

We continue to believe that, upon proper reflection, the generation-skipping problem will be perceived by Congress in terms far less complex than those implied by H.R. 6260 and H.R. 6261. This will permit a solution that is far less imposing than those now being advanced by either ALI or Treasury.

The Illinois State Bar Association would be pleased to contribute toward a proper solution in any manner deemed appropriate by this Committee.

Mr. Russo. Thank you very much.

Mr. McCue.

STATEMENT OF HOWARD M. McCUE III, CHAIRMAN, FEDERAL TAXATION COMMITTEE, CHICAGO BAR ASSOCIATION

Mr. McCue. Thank you, Mr. Russo.

I am Howard McCue. I am a member of the law firm of Mayer, Brown & Platt, and chairman of the Federal Tax Committee of the Chicago Bar Association. It is on behalf of the Chicago Bar that I appear, and we thank you for the opportunity to be here.

I must begin by indicating that it is the position, the longstanding position, of the Chicago Bar that the current chapter 13 should be repealed. You have heard a consensus on that today. We think the arguments have been made by Treasury and others; we do not want to spend a lot of time on that point.

We do not mean to suggest by our statement in favor of repeal that there can or should be no generation-skipping tax. Indeed, we certainly would not suggest that Professor Gutman's hypothetical trust, the trust he articulated for this committee this morning, must be free of generation-skipping tax in perpetuity. We are concerned about fashioning a tax that is simple and administrable.

In that regard, I would like to talk first about the credit versus exemption problem raised by Chairman Rostenkowski. We feel very strongly that an exemption approach is preferable to the credit approach. We find no particular intellectual attraction in the credit approach that swings us to that suggestion in favor of the exemption approach. And, as Mr. Zissman and others have pointed out, the credit approach increases the burdens of administration tenfold, if not a hundredfold, in terms of how you administer trusts in the real world.

We would next like to talk a bit about direct skips. It has been suggested by Assistant Secretary Pearlman and others that fairness is the reason we must have direct skips. It is suggested that this law only applies to the very rich, and therefore that you can fashion some sort of intellectually consistent system and trust the very rich to have sufficiently sophisticated planners to deal with the problems created thereby.

I am willing to concede, for the purposes of this exercise, that we are talking about a tax on the rich, though I would note from the figures in Mr. Pearlman's testimony this morning that we are talking about a group in excess of a quarter million people per generation. This is not—I think he used the figure of 9,000 deaths per year over \$1.25 million.

Mr. Russo. 2 million deaths a year.

Mr. McCue. 9,000 per year in the group that has more than \$1.25 million. That is a quarter million people in a generation. This is not the 400 families that we talked about in 1976, in articulating the reason we had to have a generation-skipping tax.

What sort of transfers will this direct skip approach tax? I think the answer is relatively simple. We are talking about transfers from grandparents to grandchildren. This was not thought to be an abuse in 1976. Mr. Baetz and others have suggested it is not an abuse. We, certainly, are not aware of empirical evidence that suggests that we can have any confidence that there is any abuse here.

The fairness argument is really a tax neutrality argument. But I think it is based on assumptions that so vastly oversimplify the problem as to make the conclusion unsound.

It has been suggested that tax neutrality will be achieved by this approach, but in fact this law, if enacted with a tax on direct skips, is simply going to encourage a new form of trust vehicle. We have annual exclusions; we have a tax-exclusive gift tax—but a tax-inclusive estate tax. We are going to favor lifetime direct transfers to children and long-term discretionary trusts for grandchildren, great-grandchildren, and more remote descendants.

It has also been noted that the tax on direct transfers will have a nasty side effect. We think it will most often be encountered in the unusual order of death situation. Mr. Pearlman indicated a willingness to work with this problem. We hope he will.

We note, also, that this tax is going to appear in many situations where a grandparent wishes to give a closely held business or farm to a grandchild who is active with him or her in that business or farm venture. We have spent the last 7 years providing special relief to those taxpayers at the estate tax level, and now we are going to hit them with a double tax that may apply at an effective 80 percent tax rate.

I would like to close with brief comments about the effective date provisions. The chairman has indicated that sophisticated advisers should proceed at their own risk, and that these dates should be fixed later.

We are happy to proceed at our own risk, but we think the effective date ought to be set promptly. I am not suggesting that there should be any window period because we would be happy with any date that relates to these hearings, and it may go back to September 18, when the proposals were introduced.

Sophisticated advisers are well aware of the problems of retroactive tax legislation. We watch that happen. In other areas we have watched the discussions of retroactive relief and seen no results. We will be wary.

If you adopt some effective date provision that relates back to a date several months (or years) before these hearings, you are simply going to trap the sole practitioner with one of two clients who is unaware of developments in the area. I do not think that is what this committee wishes to do.

[The proposed statement follows:]

STATEMENT OF HOWARD M. McCUE III, CHAIRMAN, FEDERAL TAXATION COMMITTEE,
CHICAGO BAR ASSOCIATION

SUMMARY OF POINTS

A. Responses to questions raised by Chairman Rostenkowski

1. The addition of more than one generation-skipping transfer tax on a single trust would add complexity without any clear benefit.
2. The exemption approach of the Treasury proposal is clearly preferable to the credit approach, as it facilitates recordkeeping and removes most smaller trusts from the generation-skipping transfer tax system.
3. Transferability of unused exemptions between spouses should be permitted.
4. An annual \$10,000 de minimis exemption will simplify trust administration.
5. A credit for state generation-skipping transfer taxes is appropriate.

B. Additional general comments

1. The taxation of direct skips is not necessary to promote fairness.
2. The addition of a generation-skipping transfer tax on income distributions would substantially increase the complexity of the transfer tax system, without curing any demonstrable ill.
3. The tax should be consistently either tax-exclusive or tax-inclusive—not a hybrid.
4. An effective date provision for the new law should be fixed promptly.

C. Specific comments

While some specific technical comments are provided, additional opportunity for technical comment should be afforded after the general questions discussed above have been resolved.

STATEMENT

My name is Howard M. McCue III. I am a member of the law firm of Mayer, Brown & Platt and an adjunct professor of law in the graduate tax program at the Chicago-Kent College of Law. I am also Chairman of the Chicago Bar Association Committee on Federal Taxation, and I appear today on behalf of that Association.

INTRODUCTION

Our Association seeks to be responsive to the specific requests for comment included with Chairman Rostenkowski's statement upon the introduction of the two recent generation-skipping transfer tax simplification proposals. Nevertheless, I am constrained to begin by noting that the Chicago Bar Association continues to favor repeal of the current Chapter 13.

The argument for repeal of the present Chapter 13 was eloquently made by the Treasury itself. When the predecessor to the current Treasury discussion draft was announced in April of 1983, the Treasury conceded in the introductory materials to its proposal that the current generation-skipping transfer tax is unworkable. We agree. Indeed, there seems little dispute that the current law must be repealed. The only question is when the repeal is to be accomplished.

The retention of a discredited law serves no legitimate purpose. We do not suggest that there should be no generation-skipping transfer tax of any sort. We do, however, strongly suggest that taxpayers and their advisors should not be forced to suffer further uncertainty for any indefinite period. Predictability and simplicity must be returned to the transfer tax system.

COMMENTS ON QUESTIONS RAISED BY CHAIRMAN ROSTENKOWSKI

Chairman Rostenkowski has invited comment on several specific issues. We will address them in the order raised in the introductory materials:

1. *Taxation of trusts providing for generation-skipping transfers to more than one generation.*—Under both of the new discussion drafts, only one generation-skipping transfer tax is imposed on any single trust which benefits younger generation beneficiaries in two or more different generations both younger than the transferor. By contrast, property transferred outright the children at death—once each generation and one generation at a time—is subject to a transfer tax once each generation. You have asked if this result is undesirable.

We cannot answer the question without first seeking to define what goals are sought to be accomplished by the enactment of the generation-skipping transfer tax. If the generation-skipping transfer tax is intended to discourage the use of the long-term trust for many different generations (and, indeed, this was one of the motivations of the initial generation-skipping proposals in 1976), then the new discussion drafts are a step backward. If, instead, the general-skipping tax seeks to encourage the use of trust devices in preference to outright transfers, or to discourage all transfers of whatever sort to grandchildren, the two new proposals will serve to accomplish that end.

We are not convinced that there is any good reason to add a second generation-skipping transfer tax on any single trust. Practical experience leads us to suggest that few parents create trusts for great-grandchildren or more remote descendants. The avoidance of a third tax (i.e., the second generation-skipping tax) simply is not sufficient motivation to cause parents to adopt such artificial devices in most cases. The second and subsequent generation-skipping taxes on a single trust add complexity, and they will likely come into play only when unusual orders of death—or other unusual fact patterns—cause unexpected events to occur.

2. *Credit versus exemption.*—The credit versus exemption question presents a simpler problem. Putting aside the question of what the rates should be (and we do not seek to advise you on that question), we favor the exemption approach, simply because it affords the vast majority of taxpayers the certainty, at the creation of a small generation-skipping trust, that they are not affected by this inevitably cumbersome system.

The ALI discussion draft adopts a credit approach. As a practical matter, trust administrators would be required, under such approach, to keep records as to all potential generation-skipping taxable distributions from all trusts, to protect against the possibility (often sought but only rarely achieved) that some clever investment may vastly increase the value of the trust assets and cause a trust, otherwise outside these provisions, to be brought back within the net of the generation-skipping transfer tax.

While it is true that the exemption approach may allow appreciation on property transferred in trust to escape generation-skipping transfer tax in certain circumstances, we feel this problem does not challenge the integrity of the transfer tax system. Note that this problem is not a new one. Under our existing law, a taxpayer may make a significant gift (up to \$325,000 in 1984—or \$650,000 for a split gift by a married taxpayer) to his daughter and, by using his unified credit against estate and gift tax, avoid actually paying any transfer tax on the gift until death (when the value of the gift, determined at date of gift value, is added back to the estate for purposes of computing the estate tax). The appreciation in the value of the gift property after the gift but prior to death will almost always avoid transfer taxation.

3. *Transferability.*—So long as the gift and estate tax law includes an unlimited marital deduction, it seems appropriate to permit transfers of unused exemptions (or credits) between spouses, both during lifetime and at death. We do not see how this adds complexity. If there is no transferability of the exemption or credit, competent planners will be able to structure a sequence of transaction leading up to a pair of generation-skipping transfers so as to use the credit of both spouses. We see no necessity for restrictions to prevent "trafficking" in exemptions. The spectre of such trafficking was raised in 1981 when the estate and gift tax unified credit amounts were raised at the same time the unlimited marital deduction was introduced. Those fears have proven to be unfounded.

4. *\$10,000 per year exemption for certain distributions.*—The treasury discussion draft generally provides an exemption of up to \$10,000 per year for distributions to certain trust beneficiaries. This exemption is generally available only for beneficiaries who are grandchildren of the trust grantor.

Clearly, this exemption provides a de minimis rule for trust distributions which will facilitate trust administration and will reduce the number of tax returns filed

when no significant tax is due. For the reasons indicated below, we conclude that the Treasury proposal would add unnecessary complexity by taxing distributions of income as well as distributions of corpus. If these provisions are changed to eliminate the tax on distributions of income, the necessity for a *de minimis* rule will not be so great. Nevertheless, we favor the inclusion of some *de minimis* provision to simplify trust administration.

5. *Credit for State taxes.*—The Treasury draft and the ALI draft differ on the question of whether a credit for state generation-skipping transfers taxes should be included. The difference reflects a difference in objective. Generally, we prefer the Treasury approach which provides such a credit. However, the inclusion of a credit provision may encourage a proliferation of state generation-skipping transfer taxes, and such proliferation may add complexity to the overall transfer tax system. If the state taxes are "pick-up" type taxes, it would not be difficult to compute the state generation-skipping transfer tax that is payable. It may, however, prove difficult to determine which state is entitled to collect the tax in many circumstances. Our experience in related areas suggests that the states likely will adopt differing and sometimes inconsistent rules as to tax situs for the generation-skipping transfers tax.

ADDITIONAL GENERAL COMMENTS

In addition to the foregoing, we offer the following general comments.

1. *Taxation of "direct skips".*—We note that both discussion drafts would subject to the generation-skipping transfer tax what are characterized as "direct skips" or "outright skips". A direct or outright skip occurs upon an outright transfer to or for the benefit of a person at least two generations below the transferor. The generation-skipping transfer tax would be imposed in addition to the gift or estate tax which is applied to such transfer. It is suggested that this addition to the existing scheme is necessary on fairness grounds, to eliminate an opportunity for avoidance of the intent of the transfer tax system.

In this regard, it is important first to recognize what these proposals would tax. The simple fact is that such proposals would add a second tax on outright transfers from older individuals to their grandchildren. We are not talking about transfers in trust where the parents have an intervening interest; instead, we are talking about transfers directly to grandchildren. (Theorists will point out that these provisions will also tax transfers from older taxpayers to great-grandchildren and perhaps great great-grandchildren, as well. In practice, such transfers simply do not occur with any frequency. In my practice, I have encountered only one example of a direct transfer to great-grandchildren or more remote descendants since the enactment of the 1976 provision—if you permit me to exclude insignificant Christmas and birthday presents.)

At the time the generation-skipping tax was enacted in 1976, direct transfers from grandparents to grandchildren were not deemed to be an abuse of the transfer tax system. Such transfers have always been subject to one tax, a gift or estate tax at the time of the transfer. No one thought it necessary to impose a second tax. There has been no empirical evidence to suggest that this conclusion was incorrect.

We are not convinced that such transfers constitute an abuse of the transfer tax system. Instead, we conclude that the imposition of a second transfer tax on such direct gifts will encourage the very sort of behavior sought to be discouraged. Clearly, both new proposals will favor, in some instances, transfers to trusts with multiple generation beneficiaries, because the use of such trusts will permit transferors to delay the imposition of the second transfer tax.

A tax on outright transfers likely will also have at least one nasty side effect which may not be anticipated. This tax will most commonly be encountered when an unusual order of death causes a parent—who intended no generation-skipping at all—to transfer property directly to the children of a pre-deceased child. Does fairness require the imposition of a second tax in these circumstances?

Finally, we note in this regard that, even with a *de minimis* provision, tax advisors may find themselves in the anomalous position of advising clients that modest gifts to grand-children, i.e., gifts made to assist with the downpayment on a residence or farm, to start some other small business or even to purchase an automobile, will be subject to a generation-skipping transfer tax. Note that any of these sorts of gifts may exceed \$10,000. If you enact a direct-skip tax, we will advise our clients that they must file generation-skipping transfer tax returns on such transactions. We cannot guarantee that voluntary compliance with the tax system will thereby be encouraged.

2. *Taxation of income distributions.*—Both discussion drafts would subject distributions of income to the generation-skipping transfer tax. Again, these proposals would substantially increase the complexity of the tax, and the administrative burdens attendant to its administration, in order to cure a perceived problem that was not heretofore regarded as a problem at all.

The current generation-skipping transfer tax does not tax such distributions. The legislative history of the 1976 generation-skipping tax does not suggest that such distributions were perceived to be an abuse. Rather, the original intent was to tax distributions of corpus as they move down from one generation to another. Again, we have seen no empirical evidence to indicate that there is an abuse here. We think that, in the interest of simplicity and predictability, such transfers should not be made subject to the generation-skipping transfer tax unless there is some good reason to believe that there is an abuse which requires correction.

3. *Tax-inclusive versus tax-exclusive, the gross-up problem.*—We would also like to address the problem of the "gross-up". Specifically, the question is whether the generation-skipping transfer tax should be determined on a tax-inclusive or tax-exclusive basis.

The existing transfer tax system is already inconsistent. The gift tax is generally a tax-exclusive tax; the estate tax is a tax-inclusive tax. We believe that the generation-skipping transfer tax should not be a hybrid. Differing rules on this item will encourage gamesmanship and artificiality in planning and drafting. Either the tax should be determined entirely on a tax-inclusive basis or entirely on a tax-exclusive basis. Our clients would prefer that it be tax-exclusive, i.e., that there be no gross-up. If there is any revenue loss occasioned by such a change, it can be made up by a modest change in rates.

4. *Effective date provisions.*—Chairman Rostenkowski's introductory statement emphasized that grantors of trusts and their advisors should proceed only at their own peril in establishing generation-skipping trusts in anticipation of a change in the law. He then indicated that the appropriate effective date must be fixed at a later time. We submit that the effective date provision should be fixed promptly.

Sophisticated tax advisors are all too aware of the recent trend toward retroactive tax legislation. Further, having recently endured the impact of retroactive decisions by the Supreme Court in *Jewett* and *Dickman*, with no legislative relief, sophisticated observers are doubly wary of this Committee and others having responsibility for drafting tax legislation.

We do not dispute the suggestion that it may be appropriate to make whatever new legislation may be adopted effective upon the date such legislation was first proposed, presumably September 18, 1984—or at any date thereafter. We do suggest, however, that if you attempt to go back further, with the hope of trapping those who sought to avoid the impact of the generation-skipping transfer tax, you will instead sweep into your net those—such as farmers and small businessmen—who are represented by general practitioners with no particular expertise in these matters. It is they who naively will assume that the existing Chapter 13 will some day be repealed, solely on the basis of the admission by the Department of the Treasury that the law is unadministrable.

Retroactive legislation generally has served to discourage voluntary compliance. Taxpayers who are trapped by retroactive provisions do not, in our experience, blame their advisors for their predicament. Rather, they blame their government. The self-assessment system is the loser.

SPECIFIC COMMENTS ON THE DISCUSSION DRAFTS

Finally, we would like to submit some preliminary specific comments regarding the two recent discussion drafts. We do so with trepidation, as it is most difficult for any bar association thoughtfully to analyze such complicated legislation in the short time permitted. We are helped somewhat by the fact that the bills presented to us are similar to prior drafts of this legislation distributed by the Treasury and the ALI.

We also note that there are a large number of technical concerns with each of the two discussion drafts. Preliminary indications are that additional proposed generation-skipping transfer tax systems will be suggested today. Under these circumstances, we recommend that, once the broader issues discussed above have been resolved, a clean draft statute be reintroduced for technical comment prior to further action by this Committee. Our Association would be pleased to participate either in the preparation of such a clean draft or by technical comments after it has been prepared.

1. *Treasury discussion draft—H.R. 6260.*—With these reservations, we submit the following comments on the Treasury discussion draft.

(a) *Definition.*—It is not clear that taxable terminations are always distinguishable from taxable distributions. Some events may fall within both definitions. The definition of a direct skip in trust may exclude some transfers which should be included because "nonskip" individuals may have contingent remainder interests.

(b) *\$10,000 per year exclusion.*—Many members of our Committee are concerned by the apparent trend of treating a husband and wife as one individual. It is noted that this trend has the cumulative effect of discouraging the institution of marriage.

(c) *Default allocation of unused exemption.*—The default application provisions included in proposed Section 2632 are mischievous. There should be a second category (following direct skips) including trusts from which a taxable termination or taxable distribution is certain to occur, before those trusts from which such a taxable distribution or taxable termination might occur.

The default allocation provisions involving former spouses also create uncertain responsibilities both for executors of deceased spouses with unused exemptions and for executors of those decedents who may have former spouses with unused exemptions. Simpler rules may be appropriate here.

(d) *Generation assignments.*—We question the classification of generation assignments by age as applied to employees (particularly domestic servants). It seems anomalous to treat these individuals as grandchildren under certain circumstances. Further, the rule that a typical generation is 25 years seems inappropriate; a 30 year rule would more nearly approximate the actual life span of a generation in those families who will be paying the tax and it would also simplify the arithmetic.

One of the much criticized aspects of the existing generation-skipping transfer tax was the "look-through" rule applicable to entities. Much has already been written on the difficulty of applying this rule. These problems should be addressed.

(e) *Charitable split interest gifts.*—By treating charity as a person of the same generation as the grantor, without providing any charitable deduction, the discussion draft would postpone the application of the tax in ways that will be difficult to plan for or predict. Generally, split interest giving will be discouraged. A different approach that would include a charitable deduction seems preferable to us. In this regard, we note that we are quite unable to comprehend proposed Section 2652(c)(1).

(f) *Other problems.*—There are a number of other problems. The "nominal interest" question raised by the present Chapter 13 has not been resolved. Other definitions, i.e., interests, persons, and transferees, are puzzling and merit additional attention. The IRC Section 691(c) deduction added by the related amendments should be allowed for taxable distributions as well as taxable terminations. The credit for tax on prior transfers does not apply in many circumstances (notably including direct skips) where the rationale of the existing comparable estate tax provisions would suggest that such a credit should be allowed.

2. *ALI discussion draft—H.R. 6261.*—It is quite difficult for our Association to make technical comment on the ALI proposal because that proposal embodies an entirely new approach to transfer taxes in general.

For reasons indicated above, we oppose the credit noted incorporated in the ALI draft. The introductory materials also indicate that the rules relating to the treatment of QTIP trusts and the rules relating to powers of appointment should be repealed if the ALI approach is adopted. It is not clear that the statute accomplishes this result. If it does, it is not clear how such repeal will impact the balance of the estate and gift tax law. These questions must be considered carefully before such a change is enacted.

Thank you for your attention, Mr. Chairman. I would welcome your questions.

STATEMENT OF IRA H. LUSTGARTEN, FORMER CHAIRPERSON, TRUSTS AND ESTATES LAW SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. LUSTGARTEN. Emulating the American Bar Association, the New York State Bar Association is here as a duet.

I am the former chair of the trusts and estates law section of the New York State Bar Association, for which I speak; Mr. Christensen will speak for the tax section.

The trusts and estates law section has associated itself with the position of the American College of Probate Counsel, as articulated by Mr. Moore in the last panel.

In the interest of conserving time, effort, and energy. It is not necessary to go over all the points that he made. There are some things that maybe we ought to take into consideration which are not strictly called for by the specific questions presented.

One could be led to think that almost everybody who establishes a trust is doing it to avoid taxation. That is really not so.

My will provides trusts; if my children die before they are 25, it will go to their children if they have them. In that event, there could be a tax under either of these proposals, not because I was trying to shift wealth to another generation, but just because I was trying to protect my children until they reached a certain age.

Otherwise, there would have been the imposition of a tax 40 or 50 years from now, if my children live their normal expectancies; but because of the premature death of a child before attaining a stated age, and the trust becoming distributable, outright or in trust for the child's issue, this tax is generated. That might be neat, but I don't think that is precisely what the evil was that was sought to be addressed back in 1976.

We talk about people of great wealth, the \$30 million trust for many generations, and then we say, let's have a \$1 million exemption.

Well, nobody with \$2, or \$3, or \$4 million can do the sort of layering that has been discussed. You have to have significant wealth to do layering, and if layering is the concern, and that is the reason for tax on direct skips, and I am not saying that is wrong, it seems to me as a corollary that you have a responsible, reasonable exemption.

You don't have an exemption fixed at \$1 million, because you are concerned with people who have \$30 million layering. You can't use that as an example to demonstrate an evil that hardly anybody can employ. Not everybody—more probably nobody—in this room can do it.

The Congress has said that gifts to charities are good, and established through the estate tax, the gift tax, and the income tax laws ways in which you can have split-interest charitable trusts. Both of these proposals interfere with that, particularly the ALI proposal, because you can't meet the requirements of section 664 with a payout of a guaranteed annuity amount and still comply with that generation-skipping tax proposal.

This goes far beyond just whether there should be an exemption. This is an interference with other areas that people have tried to develop in an effort to enhance the private sector.

Under the ALI proposal, for example, if I were to set up a trust for Mr. Baetz and his children—and we are in the same generation and his children are probably one generation down—because there is no generational assignment that becomes for whatever reason a generation-skipping trust. Just because we are not related—and I don't believe we are—I get caught up in the web by trying to establish a trust for a friend and his children or for someone who is older than me and his children. That is in there, too.

Are these things that we really want to tax, and indeed, where are we going? Congress has lately, it seems to me, frustrated the possibility of getting funds down to persons most likely to use them.

We are encouraging trusts. Such things as the unlimited marital deduction, unification of the gift and estate tax rates, the Q-Tip trust and so on, encourage moneys to be kept in trust so that children receive principal when they are likely to start receiving social security. Here we have another tax which is going to operate to keep funds away from people in their forties, the people most likely to invest it, not let it sit in the hands of fiduciaries who, I don't think anybody will suggest, are a source of venture capital.

Somebody has to take a look at questions, such as whether there should be a credit for a State generation-skipping tax, but where is all of this going? What is going to be the final result of having these neat taxes?

What is happening now is that everybody has tried to come up with the ultimate generation-skipping tax where nobody can point to a loophole, but after you get that, it is time to look at where it is all going.

I thank you for your time.

[The prepared statement follows:]

STATEMENT OF IRA H. LUSTGARTEN, ON BEHALF OF THE TRUSTS AND ESTATES LAW
SECTION OF THE NEW YORK STATE BAR ASSOCIATION

This statement has been authorized by the Executive Committee of the Trusts and Estates Law Section of the New York State Bar Association. The Section has almost 4,000 members, all of whom are active practitioners in the area which would be affected by the Legislation you are considering today.

We have reviewed the statement submitted by Malcolm Moore on behalf of the American College of Probate counsel. We endorse the positions taken in that statement and associate ourselves with the college for the purposes of this hearing. Nonetheless, the Section wishes to emphasize certain of its views.

DIRECT SKIP

The proposed tax on direct skips is a far cry from the original concept of imposing a tax when a significant interest had terminated without its being subject to a tax under Chapter 11 or Chapter 12. The purported use of layering by few wealthy individuals does not justify the overkill of the Treasury and "ALI" proposals. Even where the testator's or grantor's child has predeceased and there is no generation senior to the grandchild, the tax is imposed. This is indefensible. Why should the grandchild be penalized?

The attack on "layering" by the very wealthy may be rationalized only if there is an exemption amount far in excess of that in the current Treasury proposal. If the concern is that the very wealthy will layer, the direct skip tax should be imposed only upon the very wealthy (see below).

EXEMPTION LEVEL

The exemption approach is preferable to the credit approach. The net cast by the latter is far too broad. Clients and their advisors should be assured that they are once and forever not subject to the tax.

It is the unusual trust, created in the wealthiest families, which seeks to defer vesting during a child's lifetime. Most trusts that we see provide for children until a stated age but, if the child dies before that age, the principal is paid over to or held in further trust for the child's issue. The purpose of the trust is to protect the child until the child is deemed able to handle the funds.

If a widower leaves a residuary estate of \$1.5 million in trust for a child to be distributed at age 35, and the child dies before that age so that the property is distributed to a grandchild, why should a tax be asserted. This is not a tax avoidance device.

COMPUTATION OF TAX

All generation skipping taxes should be computed on a tax exclusive basis. The analogy should be to the gift tax and not to the estate tax. Whether the tax rate is

the marginal rate or 80 percent of the marginal rate, computation on a tax inclusive basis, when added to the other taxes imposed on a transfer, distribution or termination is virtually confiscatory.

INCOME

Income should only be included in the base if there is a significant and direct set-off of the tax imposed when the same event triggers an income tax.

CONCLUSION

Present Chapter 13 and the Treasury proposal deal with a tax on generation skipping transfers. The "ALI" proposal does not purport to be a tax only on transfers. Neither proposal is purely a transfer tax. Both have elements of a tax on wealth and embody the concept that wealth should be taxed in each generation. If this last is desired, both proposals should offer a full credit for tax paid on transfers within the same generation. Does Congress intend to tax wealth in each generation even where there is no transfer?

Intelligent and creative people have spent hundreds of thousands of hours over the past nine years or more trying to develop this tax. In addition to the proposals currently before your Committee, two professors at Texas A & M have recently suggested yet another approach and we understand that a major local Bar Association with the aid of a Harvard Law School professor is proposing yet a different solution. It seems almost as though the structuring of a "perfect" generation skipping tax has become an end in itself and the original policy determination has been lost sight of.

To return to first principles, that policy was that a person should not have what is tantamount to all of the fruits of wealth without it being taxed when that wealth finally vests in another person. The "layering" to be feared is the layering of provision upon provision in an attempt to tidy up an untidy system even though the amount of revenue to be produced is, in the contemplation of everyone, minimal.

STATEMENT OF HENRY CHRISTENSEN III, COCHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

I appreciate the opportunity to speak today on behalf of the tax section of the New York State Bar Association. I am cochairman of the estate and gift tax committee of the tax section.

We are in basic agreement with Mr. Lustgarten's section, with some disagreements, which lawyers always seem to have. Support for a generation-skipping tax is the primary thing I would like to state.

The tax section does support the imposition of a generation-skipping transfer tax, and we believe it important that we have a generation-skipping transfer tax to supplement the present estate and gift tax.

The present chapter 13 should be repealed, but replaced with a new tax. In general, we support the common approaches to tax which H.R. 6260 and 6261 share, with one exception, a tax on direct skips.

I'd like to summarize our written presentation.

Flat rate of tax: we endorse this simplification. We take no position on the rate of tax, but we believe that the rate must be tied ultimately to the amount of exemption from tax or credit against tax.

If there were to be a tax on direct skips at this time, which we oppose, we would apply a lower rate to a tax on direct skips.

One question which causes concern to many members of our section is the exemption level. It must be high enough to sustain with

equity a flat rate of tax, which is going to be near the highest rate under the Treasury proposal.

We do have some concern at having an exemption which is too high. We believe that the exemption or credit level and the tax rate level should be tied together to produce an equitable result, but that the result should also be that a large enough cross-section of the American population is affected by this tax, so that a sensible result is going to be produced.

With respect to exemption versus credit, we would generally favor the credit approach as a matter of tax policy. We believe that the credit is the preferable method.

We also recognize that the use of a credit will produce some very substantial administrative burdens and because of those burdens on trustees, we would accept the exemption as the best compromise if that were felt to be a necessary one.

We are opposed to a tax on direct skipping at this time. We recognize the policy reasons favoring a tax on direct skips, but we think there are significant policy reasons not to tax direct skips.

Most important, as many of the speakers this morning have stressed, taxing direct skips would impose a tax where the intervening generation had no interest in or enjoyment of the property transferred.

We do not believe that Congress has ever stated a policy to date favoring taxation upon a transfer, unless there had been enjoyment in the intervening generation. We believe there now exists or can be built a general consensus in favor of an acceptable form of generation-skipping tax; and we believe that the tax on direct skips will interfere with the process of building that consensus and would strongly urge that it be put aside and a generation-skipping tax law otherwise be enacted.

We would favor taxing income distributions from trusts, whether there are going to be taxes on direct skips or not.

We believe that income and principal of a multigenerational trust should be recognized as fungible and that income distributions should be taxed, but with the taxation of income distributions from trusts, we do endorse the \$10,000 per year exclusion from generation-skipping tax as a very necessary administrative de minimis rule for trustees trying to administer these trusts.

Again, Mr. Chairman, in principle, I believe that the bulk of the professional groups speaking have been speaking with consistency in favoring some form of a generation-skipping tax.

The broad endorsement will result in some differences within these groups as to how they feel the tax should be approached, but we do endorse in general generation-skipping tax.

[The prepared statement follows:]

STATEMENT OF HENRY CHRISTENSEN III, COCHAIRMAN, ESTATE AND GIFT TAX
COMMITTEE, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. Chairman, I appreciate this opportunity to appear before your Committee on behalf of the Tax Section of the New York State Bar Association. We have submitted a written statement, which I would like to summarize.

SUPPORT FOR A GENERATION-SKIPPING TAX

First and most important, the Tax Section does support the imposition of a generation-skipping transfer tax and believes it important that we have such a tax to

supplement the present estate and gift tax. With one important exception, the tax on direct skips, the Tax Section generally approves the provisions of the Treasury bill now reflected in H.R. 6260.

FLAT RATE OF TAX

All of the draft bills would impose a flat rate of tax at either the maximum Federal estate tax rate then in force or some lesser fraction thereof as the only tax rate for generation-skipping transfers. We endorse this major simplification. We take no position on the rate of tax selected, but believe that the rate selected must be tied ultimately to the amount of exemption from or credit against tax. If there is to be a tax on direct skips, which we oppose at this time, we would apply a lower rate to these transfers than that otherwise applicable to generation-skipping transfers.

EXEMPTION LEVEL

The Treasury bill and H.R. 6260 propose a transferable individual exemption from generation-skipping transfer tax of \$1 million. An exemption at or near this amount or a credit against tax in approximately an equivalent amount is important for fairness if the tax is to be imposed at a flat rate near the maximum rate. We would be concerned, however, at higher levels of exemption or credit because we think that the tax should not be imposed on such a tiny portion of the public as to leave no meaningful constituency to be affected by the tax.

EXEMPTION V. CREDIT

The ALI proposal embodied in H.R. 6261 would use a credit rather than a exemption. As a matter of tax policy, we favor the credit, which would result in imposing transfer tax upon appreciation in the value of property transferred in trust. Use of a credit would, however, make any multi-generation trust potentially subject to generation-skipping transfer tax at a later date if the appreciation took the value of the trust corpus past the credit ceiling. This element of uncertainty risks non-compliance and significantly greater costs for practitioners and trust administrators. We therefore find an exemption an acceptable alternative which offers the benefit of certainty, although as a matter of general policy we would opt for a credit.

TAX ON DIRECT SKIPS

The Tax Section of the New York State Bar Association opposes a generation-skipping transfer tax on direct skips at this time. We believe that Chapter 13 of the Code can be revised to constitute a coherent and complete addition to the transfer tax system without taxing direct skips. We note that the present Chapter 13 does not tax direct skips and that the choice not to tax direct skips was made knowingly and after extensive hearings, with Treasury recommending that they be taxed in its 1969 recommendations and Congress electing not to tax them in 1976.

While we recognize the policy reasons favoring a tax on direct skips, we think there are significant policy reasons not to tax direct skips. Most important, taxing direct skips would impose a tax where the intervening generation had no interest in or enjoyment of the property transferred, and we believe that Congress to date has not wanted to impose a transfer tax upon property unless the individual with respect to whom the tax is payable has enjoyed the benefits of the property. We believe that a general consensus can be built or now exists for a tax on generation-skipping transfers if direct skips are not to be taxed and we would eliminate them from the coverage of Chapter 13.

TAX ON INCOME DISTRIBUTIONS

Even if direct skips are not to be taxed, we would subject income distribution from multi-generation trusts to the generation-skipping transfer tax. While we understand that this complicates administration for fiduciaries, we believe that the difference between income and principal of such a trust is without substance and that all distributions to the younger generation should be taxed.

\$10,000 PER YEAR EXCLUSION

We strongly endorse the concept of a \$10,000 per year exclusion from tax for distributions from trusts. We think this important if income distributions are to be subject to the tax, as a *de minimus* provision. H.R. 6260 combines the husband and wife for purposes of this exemption, a policy decision which we question since a hus-

band and wife are not joined as transferees for purposes of Section 2503. We would allow an aggregate \$10,000 exclusion for annual receipts by any individual from all generation-skipping trusts.

TRANSFERABILITY OF EXEMPTION

We endorse the concept of a transferable exemption from or credit against generation-skipping transfer tax between husband and wife, as consistent with the unity approach to a marriage that the unlimited marital deduction recognizes. We support free transferability of exemption or credit between spouses in order to avoid inconsistent taxation of married couples based upon the happenstance of which spouse holds title to property. In fact, we would recommend that the unified credit against gift and estate tax under Sections 2010 and 2505 also be made transferable between spouses.

Thank you for this opportunity to testify.

Mr. RUSSO. Assuming that we are not going to repeal it and that would be the impression I get, some kind of modification of chapter 13, if we went the exemption approach, what would you gentlemen feel is a fair exemption if \$1 million is too low?

Mr. LUSTGARTEN. Some of us have looked to how Congress defined "wealth" in recent legislation, and when it gets phased in, wealth is defined as where the top bracket is hit—\$2½ million.

If that is the congressional definition of who the wealthiest taxpayers are, it would seem that that might be a place to start.

You already have some congressional definition of "wealth." You have to have \$2½ million, and you are rich. That is as arbitrary as the \$1 million, but at least there is a touchstone there to look at.

It is conceivable, looking at the discussion here today, maybe there should be different exemptions for different purposes, a different exemption level for a direct skip than for property in trust.

That is a complicating factor, but if the direct skip is there, maybe it ought to be handled separately. However, the \$2½ million does have some historical background.

Mr. RUSSO. Mr. Baetz.

Mr. BAETZ. I think it is bizarre to have to say what I am going to say. We are already at \$1 million. I never thought I would talk about a \$1 million free pass from any kind of taxation—gift, estate, income, excise, you name it.

Now, I have got to tell you with a straight face, \$1 million is too low. It is way too low. I can buy 1 million dollars' worth of 1-year term life insurance, even though I am a smoker, for under a \$1,000.

I am not wealthy today, but I if die tonight, somebody or something will be—\$1 million is not a thing that is hard to generate in this world, particularly when you look at what you fellows are doing in terms of private sector pension plans.

A frugal person who gets the Government off the hook from Social Security, by saving in a private sector pension plan, can have a big number. You have seen in the newspaper some of the numbers attributable to your IRA's into which people put \$2,000 a year.

One of the papers that I read this morning suggested \$50 million as an exemption.

The figure \$2.5 million may be too low; \$50 million is a number I can't conjure, and both numbers suggest to me, we are in fairyland, off on the wrong track when we are actually seriously considering dropping 99.99 percent of the people out from under the thing.

I would submit, we have got to go back to the drawing board and revisit what is broken. What are we trying to do, because these proposals fix a lot of things that are not broken. That is why you need the big pass to get all of us to keep from flying on airplanes down here to tell you, my God, the thing doesn't work.

The existing chapter is 7 sections long, and these two proposals are 21 and 22 sections long, and the existing chapter has tons of defined terms unknown in prior law and the new proposals have more.

That is why people keep trying to pump to these big numbers. That is the real reason.

Mr. McCUE. I have been speaking with Baetz for years, and it is always anticlimatic to follow him.

Mr. Russo. He is not subtle at all.

Mr. McCUE. Most bar association groups will be reluctant to give you rates or levels, because that is matters of policy that we have no expertise in. It ought to be clear, however, that that is a question that is tied to how you deal with direct skips, income distribution, de minimis exemptions, if you are really going to try to seek simplicity and administerability into the law, you have to look at all of these factors.

And if you are going to put all these things in, you need a big exemption level.

Mr. CHRISTENSEN. Mr. Chairman, we are not prepared to endorse any particular level, but have stated our concern that the level should not be too high. You should not drop too many taxpayers out of this tax, because we should all live with it.

Mr. Russo. That is why it makes it so easy to sit up here, the unanimity of support that we have for this particular proposal.

As someone who has introduced a bill to repeal the tax, I understand the problems that have been addressed this morning. I think it is important that we do something, and it is unfortunate we have not done it soon enough.

We have to take certain actions to protect certain individuals from making mistakes that may have been created as a result of this extremely complex law.

My opinion is, we will have some kind of generation-skipping tax enacted within the next year or so. I just raise that as an issue.

Mr. Russo. Our next panel will be the State Bar of California, the Boston Bar and the Connecticut Bar Associations.

Mr. JACOBS [presiding]. Proceed in your own manner.

STATEMENT OF CLARE H. SPRINGS, STATE BAR OF CALIFORNIA

Ms. SPRINGS. I am Clare Springs, a member of the State Bar of California.

As with others who have and will testify today, we believe the first order of business is to urge your immediate repeal of the present law. Please take the tax practitioner and his client out of this state of limbo caught betweenst and between, damned if you do, damned if you don't.

Virtually all interest groups have agreed that the present law is impossible. As set forth in the State Bar's written testimony, delaying repeal until a workable and fair solution has been found may

be creating more damage than good to our voluntary self-assessment tax system.

We do not believe that the generation-skipping problem is nearly as serious as it is perceived to be. The data on which the perceived problem of generation-skipping is based is both old and outdated.

Because of changes in the economics of our times and other social factors, including the changing role of women in our society, we believe generation-skipping trusts are being used less than they used to be.

The costs of trust administration have skyrocketed, and women are now better equipped to manage their own financial affairs. If generation-skipping continues to occur for pure tax avoidance purposes, it occurs only in situations of vast wealth; those individuals who have many millions of dollars to dispose of, not just a million or two.

Assuming that it is thought desirable to tax these situations of superwealth, the countereffect of imposing this tax should be examined first. The generation-skipping tax will implement a tax policy which promotes and encourages the concentration of wealth in the hands of the first younger generation. Our present tax system, without a generation-skipping tax, is neutral on this issue and many would say that it favors fragmentation of wealth.

Only after this issue has been squarely faced can we turn to how, if at all, the generation-skipping problem should be addressed.

As you can see, we strongly disagree with the Treasury's position that the generation-skipping tax will cause neutrality in the distributions between transfers to children and to grandchildren.

Both of the proposed statutes represent substantial steps toward simplification and improvement over the present generation-skipping law.

However, before a final resolution can be found, the policy behind the generation-skipping tax must be clearly established.

In 1976, the problem was identified as the enjoyment of property more than one generation without the payment of a transfer tax. As originally conceived, the generation-skipping tax was to tax those transfers which in fact did not skip a generation.

Do we now believe that the publicity of the estate planning technique of layering, that is, giving some property to each living generation rather than all to the oldest living generation, has caused the inclusion of the direct skip?

The proposals before us include a tax on the transfer of property directly to the grandchild's generation. The State Bar of California opposes the inclusion of the direct skip in the transfer tax base.

First, those who enjoy the use of direct skip property already pay a transfer tax. Indeed, not for one moment is that property out of the estate and gift tax realm.

Second, we believe the abuse known as layering has been widely overstated, and is not used as a common planning technique. Many children will raise a hue and cry at the very idea of being skipped.

Third, the inclusion of the direct skip in the tax base converts our estate tax into a multitiered inheritance tax and, as previously mentioned, will promote the concentration of wealth in fewer hands rather than its distribution in many.

This policy reversal is further accentuated by the fact that individuals to whom the generation-skipping tax is directed are exactly those individuals who have sufficient wealth that Congress previously thought should be fragmented and redistributed.

Finally, and most dramatically, I believe, regardless of any policy consideration, taxpayers will find the application of the direct skip to the situation where there is a predeceased child unjust and offensive.

Indeed, it came as somewhat of a surprise that this exception was not included in either of the proposals.

Treasury has stated that they do not think the predeceased child situation would be a common one. We disagree. We believe the most common occurrence of the direct skip tax will be in those situations where there is a predeceased child.

We are also concerned about the two ways in which the tax is computed, based on the type of transfer that is made. One is a tax inclusive, which includes a tax on the tax, and the other is a tax exclusive.

In two of the three types of generation-skipping transfers, the theory behind the tax is that of the gift tax, giving property to the child who immediately turns around and gives it to the grandchildren.

Only in the taxable termination is the estate tax model appropriate. We believe for simplicity and ease of administration, there ought to be one type of tax computation, the gift tax model.

You have also asked us to comment on several other issues, all of which, as well as other important issues, have been addressed in our written testimony.

We appreciate the opportunity to be heard and the California State Bar stands ready to participate in any collegial effort to find a solution to this problem.

Thank you.

[The prepared statement follows:]

STATEMENT OF CLARE H. SPRINGS, ON BEHALF OF THE STATE BAR OF CALIFORNIA

SUMMARY

Mr. Chairman and Members of the Committee, my name is Clare H. Springs. I am pleased to appear before you today as spokesman for the State Bar of California.

The State Bar of California has formerly taken a position in favor of outright repeal of the present Chapter 13 of the Internal Revenue Code. The State Bar of California continues to support immediate repeal while Congress and various professional groups continue to grapple to find a satisfactory solution to the problem of generation-skipping.

Both Treasury and the American Law Institute are to be commended for their efforts to simplify the generation-skipping tax. However, both proposals include changes which raise fundamental questions about the nature and application of our transfer tax system, including the frequency at which a transfer tax is imposed. The State Bar believes these issues must be thoroughly considered if Congress is to avoid the mistakes made in 1976.

Whether the final frame work is the Treasury proposal or the ALI proposal, the State Bar of California believes the inclusion of direct skips in the transfer tax base is unnecessary for the integrity of the transfer tax system and purports to address a non-existent problem. It will increase complexity both in planning and in determining the amount of tax. Furthermore, inclusion of direct skip converts our transfer tax system from an estate tax to an inheritance tax which, in essence, reverses existing tax policy, encouraging the concentration rather than fragmentation of family wealth. Even if in the final analysis, direct skips are included in the tax base, fair-

ness dictates that direct skips to grandchildren in the case of a predeceased child should be excluded.

The inclusion of trust income distributions in the tax base will significantly increase the administrative burden on trustees without a significant increase in revenue. If distributions of trust income are to be included in the tax base, a \$10,000 de minimis rule will reduce the imposition and consideration of a generation-skipping tax on nominal amounts.

For administrative ease, the State Bar of California supports one method of tax computation for all generation-skipping transfer. Since the majority of transfers are made in a gift tax mode, we believe the tax exclusive model should be adopted.

Simplicity and ease of administration are strong reasons for support of an exemption over a credit approach. Transferability of the exemption between spouses is necessary for equity among the different property jurisdictions.

We are most anxious to have a solution to the generation-skipping controversy that is fair to both taxpayer and the government. Any solution should provide neutrality in the planning process so that tax considerations are not the motivating factor for the taxpayer determining when, how, how much, to whom and in what form transfers of property should be made.

STATEMENT

Mr. Chairman and Members of the Committee, My name is Clare H. Springs, and I am here today representing the State Bar of California of which there are more than 80,000 members. I am a member of the Executive Committee of the State Bar's Estate Planning, Trust and Probate Section and I am a partner specializing in estate planning, tax and probate matters in the San Francisco law firm of Dinkelspiel, Donovan & Reder.

The State Bar of California is grateful for this opportunity to testify in connection with the Committee's consideration of H.R. 6260 and H.R. 6261 for simplification of the generation-skipping transfer tax.

I. HISTORY OF GENERATION-SKIPPING TAX

Chapter 13 was enacted as part of the Tax Reform Act of 1976. At the time of enactment, it was not given a thorough review by the professional groups involved in estate planning. Almost without exception, Chapter 13 is now thought to be a failure.

In August, 1981, the American Bar Association went on record in favor of its repeal. Hearings held in November, 1981 on Chapter 13 involved many professional groups, all of whom testified in favor of immediate repeal; even Treasury conceded that the law was not administrable.

On April 29, 1983, nearly eight years after its enactment, the Treasury Department introduced in essay form its proposal for simplification of the generation-skipping transfer tax. With some modification, the Treasury proposal, as it will be referred to in this testimony, is before us today in the form of H.R. 6260.

Concurrently with Treasury's efforts to develop a suitable and workable solution to Chapter 13, the American Law Institute, aware of the widespread and well founded criticism of Chapter 13, undertook its own Study on Generation-Skipping Transfers Under the Federal Estate Tax. The ALI proposal, as it will be referred to in this testimony, is before us today in the form of H.R. 6261.

Both organizations are to be commended for their efforts to find a solution to the generation-skipping tax "problem."

The State Bar of California has not completed its indepth review of each statute and looks forward to the opportunity to work with other professional groups to put forth technical comments on each statute after our review has been completed. In the meantime, the introduction of the two statutes raises several fundamental issues about the structure of the statutory framework of a new Chapter 13. The State Bar has reached some preliminary conclusions on these issues which will be addressed in its testimony today.

II. IMMEDIATE REPEAL REQUIRED

As other groups will testify today, immediate repeal of Chapter 13 is essential and justified. Since it is evident that the law will never be adequately enforced, there is no justification for leaving it on the books, even for a short time. To do so just perpetuates the morass in which taxpayers have found themselves since 1976 with respect to Chapter 13.

We understand the reluctance to repeal the present law without a substitute, but we believe that more damage is being done by continuing to leave taxpayers and their lawyers in the present state of limbo than would be done by immediate repeal.

First, there are those tax practitioners who will continue to try to comply with the present law. Because of the failure of immediate repeal, many experienced practitioners are forced to expend hours of time learning the law, to apply it to existing estate planning situations and to charge clients for their tax-planning services. The income tax deductions for generation-skipping tax planning have probably exceeded the revenue collected under Chapter 13. To demonstrate that this is not just a case of "crying wolf," a legal malpractice lawsuit is presently pending in which one of the largest law firms in Texas is defending an attorney who ran afoul of the complex transitional rules under Chapter 13 and in which a well-known author on generation-skipping is serving as an expert witness for the plaintiff.

Compliance with the present law also results in tortured estate plans that will no doubt have to be changed when the present law is repealed. As long as the present statute remains, many taxpayers find themselves in the absurd position of having no federal estate and gift tax consequences involved in their estate planning because of exemptions, deductions and credits, but they have to consider the implications of Chapter 13 on their planning if they want to avoid its tax bite.

The other side of the compliance issue is the far greater number of practitioners who are simply ignoring Chapter 13 on the grounds that Treasury is not enforcing it and it will eventually be repealed. This disregard for the present law sets a dangerous precedent, further jeopardizing our strained voluntary self-assessment tax system. As we all know, the child who gets away with stealing the first candy bar has a much easier time stealing the second.

At the present time, attorneys and other tax practitioners render considerable assistance to the government in the enforcement and collection of the estate and gift tax. While most people understand the requirements of filing annual income tax returns, they do not understand the rules governing the estate and gift taxes. Rather, as each is an occasional tax, taxpayers rely on their attorneys or accountants to advise them in this regard. Without this advice, it is difficult to estimate how many returns would inadvertently as well as intentionally not get filed. Unfortunately, this cooperative team attitude between the government and the estate planning community is breaking down with respect to generation-skipping taxes. If there is to be retroactive repeal of Chapter 13, it seems far more important on balance to avoid any larger scale ignorance of the law than to delay repeal of Chapter 13 until a substitute has been enacted.

The third argument in favor of immediate repeal is that a simple, logical and understandable solution to the complex question of generation-skipping cannot be found quickly. While both proposals before us represent significant progress toward finding a solution, neither proposal is yet satisfactory. All of those involved in Chapter 13—Congress, Treasury and the estate planning community as well as taxpayers—cannot afford to repeat the mistakes of 1976. The time and expense put into generation-skipping since 1976 on all sides has been staggering. The efforts of all these groups should be addressing the solution to this problem, not worrying about the compliance with or enforcement of an all but extinct (but not quite) present Chapter 13. The final solution will take time to develop and there is not worthwhile reason to force compliance of the present Chapter 13.

For the foregoing reasons, the first order of business should be the immediate repeal of the present statute. Only after repeal of the present Chapter 13 can the leaders of the estate planning community take time away from compliance to review and study the proposals before us today in an atmosphere conducive to producing, if possible, a workable, fair and effective tax on generation-skipping transfers.

III. FUNDAMENTAL ISSUES INVOLVED IN BOTH PROPOSALS

Both statutes, although quite different in format, represent a substantial improvement over, and simplification of, the present law. However, several aspects of both proposals warrant thorough discussion to determine if they are necessary for a fair and equitable tax.

Among the criticisms lodged against the present Chapter 13 is that it is too broad in its scope; too many taxpayers are snared in the Chapter 13 trap. In two important aspects both statutes further broaden the scope of generation-skipping. First, there is the expansion of the definition of generation-skipping transfers to include all direct transfers to persons more than one generation younger than the testator or donor, the "direct skip." The scope of the tax is also enlarged by encompassing

certain distributions of trust income to a grandchild or other person in more than one generation below the donor. The State Bar does not believe that this widening of the scope of Chapter 13 is warranted or necessary.

Another criticism brought against present Chapter 13 is that it is too complex. While the deletion of the "deemed transferor" and the "powers" rule have simplified the application of the tax, the Treasury proposes different methods of tax computation depending on whether the transfer is testamentary or inter vivos, or outright or in trust adds an entire new layer of complexity to the problem.

Finally, a third criticism frequently heard about the present Chapter 13 is that too many taxpayers whom Congress intended to exclude from the operation of Chapter 13 are in fact ensnared in its net. While the exemption level of the Treasury proposal and the credit level of the ALI proposal are a meaningful step in the right direction, the exemption and the credit levels must be high enough not only to remove taxpayers from the application of the tax but also to exclude them from the planning process for taxable generation-skipping transfers. The State Bar believes that the levels should be high enough so that the generation-skipping tax is never greater than the gift or estate tax paid in connection with the same transfer. In addition, the levels must be high enough to exclude all but the very wealthy whom Congress indicated in 1976 were the taxpayers to be subjected to generation-skipping transfer taxes.

A. Direct transfers are not an abuse and should be exempt

Both statutes before us include for the first time transfers of property which completely skip the intervening generation, the direct skip. Thus, also for the first time, our tax laws will purport to tax a transfer when none in fact has taken place and where no economic benefit has been gained. Three arguments have been made in favor of the inclusion of the direct skip. First, it is needed to prevent "layering" (that is, giving some property to each living generation rather than all to the eldest living generation); second, it simplifies the tax; and third, it creates logical consistency throughout the transfer tax system.

First, layering is not in fact an abuse of the transfer tax system. Treasury has previously stated that comparable wealth should bear comparable tax burdens, and, thus, the inclusion of direct transfers below the child's generation is appropriate, the generation-skipping approach. But the problem with this analysis is that comparable benefit or enjoyment of wealth ought to be the test of whether comparable tax burdens should be imposed, the generation-sharing approach.

The 1976 legislative history of Chapter 13 clearly indicates that Congress' sole concern was the enjoyment of wealth by intervening generations without the payment of a transfer tax. Congress was not concerned with gifts to grandchildren and younger generations where no one else had enjoyment of the property. In other words, despite its name, the generation-skipping tax was originally conceived to tax those transfers which did not in fact skip a generation except for tax purposes.

Aside from the fact that there is no enjoyment by the intervening generation of the property subject to the direct skip, our transfer tax system has never before tried to dictate to whom one should leave his or her property. There is nothing fundamentally abusive, wrong or adverse to public policy in deciding to give property to a grandchild or other individual more than 37½ years younger. Indeed, it is difficult to find a rationale for penalizing outright gifts to younger generation beneficiaries, particularly when the intervening generation is deceased. In such circumstances, the transferred property is not outside the estate and gift tax realm for a minute; the transferor will pay a gift or estate tax before the transfer and the recipient will be so taxed on the transfer thereafter. Whether it is abusive in this context to pay only an estate or gift tax and not a generation-skipping transfer tax is certainly not suggested in the legislative history underpinning the current Chapter 13.

The tax on direct skips assumes, albeit incorrectly, that absent tax motivation, all grantors would always transfer all property down only one generation to their children. This is just not the reality of life. For example, in the last decade when the costs of education have increased so dramatically, many grantors have given or willed property to grandchildren to help defray educational expenses. This is but one of many examples of where the recipient's needs, rather than the recipient's generation level, motivate the taxpayer to make the transfer. While much has been written about "layering" by estate planning gurus, few clients are willing to employ layering solely for tax savings purposes because of the familiar dissatisfaction and friction that such a dispositive scheme often engenders.

The policy behind the inclusion of direct skips appears to be that a transfer tax should be imposed at each generation no matter what the circumstances. However, there are times and situations when policy considerations should give way to the

practicalities of life such as when there is a predeceased child. Regardless of any policy considerations, taxpayers will find it outrageous that there is to be a "tax penalty" on property passing to a grandchild whose parent is deceased. Frequently the circumstances surrounding the premature death of child, through war, disease or accident are tragic and traumatic enough.

The country will view the application of the direct skip rule to the children of a predeceased child who never had even vicarious enjoyment from the property as unduly harsh as well as unfair. No policy consideration will answer why a family without a living child should be taxed at the child's generation in the same manner as if the property were given to the child who enjoyed some, if not all, the benefits therefrom during life before passing it to the grandchild. No amount of simplicity can justify such patent unfairness. Indeed, in 1976, at the same time that the present Chapter 13 was enacted, Congress expressed special concern for this situation by enacting the orphan's deduction which recognized that children with deceased parents frequently need more financial assistance than those whose parents are living. The enactment of the tax on direct skips will now penalize those same orphans. We have gone from the orphan's deduction to an orphan's tax in a few short years.

The State Bar of California strongly believes that social policy should override tax policy in this instance and an exception to the direct skip rule should be made where the parent who belongs to the intervening generation has predeceased the transferor. The concept involved is easy to explain and easy for taxpayers to understand; if the exception is not included in the final statute, the hue and cry will not be from tax and other estate planning professionals as has been true to date, but from taxpayers themselves who through lack of understanding have been relatively quiet so far.

The second argument put forth in favor of the tax on direct skips is that it will simplify the tax. Simplicity without a strong policy basis is not adequate justification. Nevertheless, we believe the tax on direct skips adds complexity to the law. For example, there will be a new choice to be made in the planning process. Does the taxpayer want to pay the generation-skipping transfer tax now or defer it by use of a trust? Also, there is the difference in the tax computation and the amount of tax imposed between direct skips and some transfers in trust.

The tax on direct skips in reality converts our present estate tax to a complicated multi-tiered inheritance tax. Under either statute, the country will have a transfer tax system which exempts spousal transfers, imposes one rate of tax on children, nieces and nephews, and others less than 37½ years younger than the transferor and imposes a higher rate on grandchildren, great nieces and great nephews, and others who are more than 37½ years younger. Within the latter category, the rate on a lifetime gift will be different from the rate imposed on a testamentary gift. Still further differentiation results from whether the gift is outright or in trust. This can hardly be considered "simplicity", nor is it in keeping with the basic policy of a unified transfer tax system.

Furthermore, if Congress wishes to abandon the use of the federal estate tax as a tax on the transfer of property in favor of a tax based on the receipt of property and to assign different tax rates based on the relationship and relative age of the recipient to the transferor, then it should be done with enactment of an inheritance tax and the contortion of the estate tax by Chapter 13 should be abandoned.

In connection with any discussion about the estate tax versus inheritance tax effect of our transfer tax system, the overall public policy with respect to transfer taxes must be considered. It has long been the public policy of this country that the transfer tax should encourage the fragmentation and redistribution of wealth and, indeed, statistics indicate that such fragmentation and redistribution is occurring. Under either statute, the application of the different tax rates based on the relationship of the recipient to the donor will encourage further concentration of family wealth in the hands of the children. Some would say that the encouragement of such a policy is against the public interest.

This dramatic policy change to include direct transfers deserves very careful consideration before enactment. Not only is this not a step toward simplification but it is a substantial reversal of prior policy. Some commentators have also questioned whether there is in fact a problem which needs correction by a tax on direct skips.

Finally, the argument is made that "logical consistency" requires a tax on the direct skip. Our transfer tax system is not logically consistent aside from generation-skipping. If logical consistency is a stated objective, then it must be fairly enacted; it cannot operate only in favor of the government. If logical consistency requires that a tax be imposed at each generation, then it is only logical that no tax should be imposed when the property is transferred within the same generation,

such as when it passes to a brother or sister and, to carry the argument to its logical conclusion, there should be a refund when property passes up the generation line to a parent or any other person more than 12½ years older than the transferor.

The State Bar believes the tax on the direct skip is unnecessary, unfair and adds considerable complexity to both statutes. Moreover, this portion of both statutes could be excised without significantly affecting the remaining portions of the statutes.

B. Inclusion of trust income

If one of the stated goals of the statutes before us is to simplify the tax, the addition of distributions of income to the tax base adds considerable complexity and poses some theoretical problems as well.

From a practical standpoint, the tax on trust income when combined with state and local income taxes will require a trust in some jurisdictions to generate approximately \$100,000 of income to leave \$20,000 for the beneficiary. This level of taxation is just too high, particularly in light of the basic policy of our present income tax to take only one-half of it. Additional complexity will be encountered in trusts where a portion of the income is accumulated for later distribution during the trust's term.

The 1976 legislative history of Chapter 13 states that trust income was excluded from the tax base as a matter of administrative ease. Nothing embodied in the statutes before us changes that initial reasoning. Therefore unless further complexity is desired, the trust income exclusion should be retained to advance the ease of administering the revised generation-skipping tax.

The State Bar believes that under any theory the income from a generation-skipping trust should be excluded from the tax base. There should be no differential between transfers in trust or outright. The administrative burden of keeping track of small income distributions outweighs the benefit from the tax collected.

The Treasury proposal includes a \$10,000 de minimis rule for testamentary trusts which the State Bar strongly supports, particularly if income is to be included in the tax base. This de minimis rule will reduce the administrative burden on smaller trusts. Trustees will not be forced to keep detailed records of small amounts distributed to grandchildren or other second generation beneficiaries. Moreover, this rule is preferable to a special allocation of all distributions either annually or cumulatively because it is simpler and will not require the employment of tax professionals to determine the proper method of allocating the distributions. Finally, it will avoid a proliferation of generation-skipping tax returns for nominal amounts.

C. Method of tax computation

With the inclusion of direct transfers in the definition of generation-skipping transfers, the computation of the tax becomes two-pronged. The Treasury proposal urges a different tax treatment for the direct skips than for the true generation-skipping trusts. The result is that there will be a varying amount of tax paid on the same gift to the same person depending on whether it is made during the donor's lifetime, at death, outright or in trust. This results in a substantial departure from the stated policy of the transfer tax rates to treat all types of transfers the same from the rate standpoint.

The differential between the tax exclusive gift tax model for the direct skip and the tax inclusive estate tax model for transfers from generation-skipping trusts results in approximately a 13% spread in the transfer taxes paid, depending solely on the manner in which the transfer is made. This will unnecessarily complicate the planning of estates and will put pressure on testators to use direct skips to save taxes when a trust is otherwise preferable for non-tax reasons, particularly in the case of young adults who might divert such outright gifts to radical political or religious groups which often attract the young and immature.

If the theory behind the tax on direct skips is that upon receipt of the property, the donee immediately makes a gift to the generation-skipping beneficiary, then the transfer is similar to a gift and the gift tax model should apply. Similarly, the gift tax model should apply to taxable distributions because the same theory applies, e.g. the donee upon receipt makes an immediate transfer to the generation-skipping beneficiary. Only in the case of taxable terminations occurring on the death of the intervening generation is the estate tax model appropriate. Since in most instances the gift tax model is the theoretically correct one, and since our efforts are to simplify, one method of computation should be employed and it should be the tax exclusive model. The simplicity gained by the use of the flat rate has been taken away by the complicated two-pronged method of computation.

An issue has been raised as to whether a credit for state generation-skipping taxes should be included in the statute. Although this adds a degree of complexity to the federal tax computation, it will be an incentive to the states to collect the

credit amount rather than developing a separate generation-skipping tax system. We have no special expertise to comment on the merits of revenue sharing, but any provision which will reduce the opportunity for the states to add another layer of complexity to the generation-skipping tax should receive Congressional support.

D. The exemption and the credit

We commend the Treasury for setting an exemption level which will allow small trusts to ignore Chapter 13. As previously stated, the level at which property becomes subject to generation-skipping must be high enough to exclude all but the wealthiest taxpayers from generation-skipping transfer taxes. The minimum level should be such that the generation-skipping tax does not exceed the tax paid under Chapter 11 or 12 on the same transfer after the use of all available credits and deductions, excluding the marital deduction. In other words, a transfer which attracts an estate or gift tax at rate below 44% should not be subject to generation-skipping tax.

There has been some criticism lodged at the proposed transferability of the exemption between spouses because this will permit abuse. We do not believe that there will be abuse in this regard. Individuals, although motivated to save taxes, are not so motivated as to take on the responsibilities of marriage merely to save taxes. We have seen very few taxpayers who have tried to divorce and remarry to get around the higher rates on income taxes for a married couple with near equal incomes. We do not see death bed marriages to utilize the marital deduction. Marriage is just too significant an event to be motivated solely by tax savings, particularly tax savings which do not benefit the person getting married but only his or her relatives and friends. Keeping in mind that those who might be tempted to traffic from the exemption will desire to shelter at least \$2,000,000 in generation-skipping taxes, consider the price of the potential divorce settlements these individuals will face if the marriage does not succeed.

More importantly, free transferability of the exemption will also create equity between the community and the separate property jurisdictions, not unlike the original enactment of the marital deduction. This point is significant since, according to the October, 1984 issue of *Forbes* magazine almost three-fourths of the 400 wealthiest individuals in this country have earned their fortunes, not inherited them. Thus, those with earned fortunes residing in community property jurisdictions will have the opportunity to apply two exemptions whereas in separate property jurisdictions if no transferability is allowed, the earning spouse will either have to create a marital deduction trust or forego the use of the other spouse's exemption. The flexibility and overall fairness achieved by the free transferability of the exemption far outweighs its potential for abuse.

IV. WHETHER AN EXEMPTION OR CREDIT

The Treasury proposal employs an exemption of one million dollars to exclude small estate owners from the onerous impact of the generation-skipping tax while the ALI proposal uses a credit of a slightly lesser amount. Each mechanism has some merits and some drawbacks.

The credit approach has the substantial advantage of being fairer in that all trusts are potentially subject to generation-skipping taxes. The credit reduces the opportunity to plan around the imposition of the tax both in the initial establishment of a generation-skipping trust as well as in the timing and manner of distributions. Moreover, the ALI proposal will tax appreciation as it is distributed, whereas the exemption will allow the donor or his or her personal representative to allocate high appreciating assets to the exempt trust and depreciating or wasting assets to a taxable trust.

Yet, the credit approach has some substantial drawbacks. All trusts no matter how small, whether designed to be generation-skipping or not, will be required to file returns and keep records. All trustees will have to be aware of Chapter 13 and its consequences. These are both criticisms which have been aired against present Chapter 13. The vast majority of trusts in this country do not approach the exemption or credit level and will never absorb the credit completely. Thus, the burden which the credit approach places on these small family trusts may create undue and unwarranted hardship without a compensating effective counterbalance. The inclusion of small trusts with their often unsophisticated trustees in the generation-skipping statutory framework will add to the expense of trust administration by requiring trustees either to become knowledgeable about the law or to employ accountants or attorneys to assist in the administration. On balance, therefore, it would appear that the simplicity of the exemption which would exclude all of the small trusts

from the operation of a Chapter 13 tax is justified and should be the approach adopted.

V. REVERSALS OF AND CHANGES IN TAX POLICY

While both the Treasury and the ALI proposals are fairer, simpler and more workable than present Chapter 13, both include a number of previously expressed and enacted transfer tax policies which are being reversed or ignored. Careful examination should be given to these policy changes, particularly any change which will concentrate greater wealth in the hands of the first generation below the transferor rather than fragmenting substantial fortunes among several generations as has been successfully done during the last thirty years.

A partial list of such changes in tax policies would include the following:

1. Loss of unification of the transfer tax system under both proposals, albeit in different ways. Tax considerations will once again become a motivating factor in deciding when, how, how much, to whom and in what form gifts should be made.

2. Transfer taxes will be based on the right to receive property rather than the right to transfer property. The age and relationship of the recipient to the donor will determine the rate of tax. Thus, we will have a federal inheritance tax rather than a true estate tax.

3. The exclusion of inheritances from income tax pursuant to Section 102 will be eliminated as far as income distributions from some generation-skipping trusts are concerned. Income will now be subject to transfer tax.

4. Both proposals with their double tax bites will encourage greater concentration of wealth in the child's generation, and disfavor the voluntary fragmentation and redistribution of wealth, a stated fundamental objective of the transfer tax system. Statistical evidence shows that fragmentation has been successful in the last 30 years.

VI. CONCLUSION

Although both Treasury and ALI are to be commended for their efforts to simplify the tax, the proposals include changes which raise fundamental questions about the nature and application of our transfer tax system. While Congress and various professional groups grapple to find a solution to these generation-skipping policy questions, present Chapter 13 should be repealed.

Whether the final statutory framework is the Treasury proposal or the ALI proposal, we believe the inclusion of direct skips in the transfer tax base is unnecessary for the integrity of the transfer tax system and purports to address a non-existent problem. Even if in the final analysis direct skips are included in the tax base, fairness dictates that direct skips to grandchildren in the case of a predeceased child should be excluded. Also, if distributions of trust income are to be included in the tax base a \$10,000 de minimis rule will reduce the imposition and consideration of a generation-skipping tax on nominal amounts.

Simplicity and ease of administration are strong reasons for support of an exemption over a credit approach. Transferability of the exemption between spouses is necessary for equity among the different property jurisdictions.

The State Bar of California appreciates being given the opportunity to be heard on this proposed generation-skipping legislation.

STATEMENT OF RAYMOND H. YOUNG, CHAIRMAN, GENERATION-SKIPPING TRANSFER TAX SUBCOMMITTEE, BOSTON BAR ASSOCIATION

Mr. YOUNG. I appear for the Boston Bar Association, and I am Raymond Young. We are your front-line tax collectors. In addition to advising clients about minimizing taxes, we actually see that they pay their death and gift taxes.

We have to administer the law in the first instance, report the transactions, and see that the tax is paid.

We come here today because we are concerned about the problem of chapter 13 and the appalling condition of a law that is not understood that is on the books, and is unenforceable.

We think that it is destructive of our voluntary-tax system. We want, if there is to be any generation-skipping transfer tax at all,

we want something simple, understandable, easily applied, applied early on, and that you don't have to follow forever.

We have looked at both Treasury and ALI proposals. In combination with the other speakers, we feel that the Treasury exemption approach is preferable, because it removes so many trusts from the system, eliminating the need to follow and keep the records involved in a credit approach.

However, we are obliged to point out to you that if Treasury is adopted or anything like it, it will be an inducement to generation-skipping. You will have more generation-skipping than you ever had under pre-1976 law, and there will be a greater erosion of the tax base, because you will have the banks, lawyers, financial planners, and all others saying, here you are, this is a specially created opportunity for you. Congress has said you can take \$1 million, put it aside, no generation-skipping tax.

It can last forever, no matter how much it appreciates. It can last within the period of the rule against perpetuities. No matter how much it appreciates, you will never have to pay the generation-skipping tax and nothing more than the original transfer tax.

From the observation I have had of the pressure when Congress creates anything of this sort, I know that there will be an enormous impetus to the establishment of long-term generation-skipping trusts by any such approach.

In the Boston Bar Association, we thought, what can we do? What kind of tax could be established if there is any need—about which we have considerable reservation, incidentally? If there is any need, what can you have that you can look at at the moment of death or at the moment of the gift, the Treasury examiner can be prepared to examine the situation at that time, trained to do it, trained to determine the tax, collect it, if it works, and put it in.

We think that tax lawyers and clients are not like donkeys in all respects, but that they may be like donkeys in one respect.

It may be easier and more satisfactory to use the carrot than the stick. If there is a concern about generation skipping, let's offer a benefit to those who do not skip. Let's offer a reduction in rates, or a credit to those who make a nonskipping transfer.

If you determine that figure correctly, there will be no net-tax loss because you will have then the funds available in the transferee's hands in the first generation, and subject to the full tax when passing from the transferee's hands.

We would believe that if there is a problem, this is a simple, readily effective way of dealing with it. Use the carrot: qualify for the benefit, avoid the extended trusts.

If you wish, it can be combined with an increase in rates, if you are concerned about the rate loss in the tax system.

The Boston Bar Association, or some members of it, have asked to have such a proposal drafted, and it is included as part of my statement as an appendix, and we would be glad to work with the staff further on it, if they wish.

I should say that it has not been approved formally by the probate committee or the council of the Bar Association because of time, but we commend it to you as a worthy approach and something which we think would solve the problem simply, expeditious-

ly, with no complexity of administration, and we offer it as a suggestion.

I might make a couple of comments on exemption level, which would apply in our proposal or whatever you do, and there have been some questions about what is the proper level.

I have been listening here today, and based on what I have heard, I can make some suggestions. Mr. Gutman used an example—I am sorry—Mr. Pearlman, who used the example of a family of \$3 million, one child and some grandchildren.

He couldn't really take advantage of generation-skipping because he wouldn't want to deprive his child. Then he said there is a family with \$30 million where generation-skipping could be used. All right, your answer then is somewhere between \$3 million and \$30 million for the exemption.

Mr. Gutman did say, use an example of \$2 million, reduced to \$1 million in the first tax, and then that would be available in the next generation, but with \$1.2 million as an exemption, equivalent for husband and wife, that is already out of the taxable structure in that second generation, so that obviously, you would be looking for something over \$2 million there.

Carl Shoup's study of 1957 and 1979 estate-tax returns, the most recent study you have, refers to large estates, defined as \$1 million or larger at that time, as presenting more generation skipping than smaller estates.

That \$1 million, again translated to today's terms, is \$3.5 million. So however you approach it, you are looking at an exemption level, some where \$3.5 million or up, I suggest.

Thank you.

[The prepared statement follows:]

STATEMENT OF RAYMOND H. YOUNG, CHAIRMAN, GENERATION SKIPPING TRANSFER
TAX SUBCOMMITTEE, BOSTON BAR ASSOCIATION

The Boston Bar Association has a membership of 5,600 lawyers. We like to think that our positions on matters of public interest are taken, not to advance the interests of our clients, and not solely in accordance with the interests of our members as lawyers, but rather in accordance with our judgment of the public good.

Boston has been known as a center of trust administration and trust planning for over a century. We speak from that experience and background. We would like to point out that not only do we lawyers advise clients with respect to minimizing taxes in estate planning, but also we are the first line tax collectors, actually reporting, calculating, collecting and paying over the taxes due on estates and gifts, some 6 billion dollars a year. We make a major contribution to the success of our voluntary compliance tax system.

The Boston Bar Association has not frequently felt called upon to testify before committees of Congress on tax or other matters. To the best of my knowledge the generation skipping transfer tax is the only tax matter on which the Association has ever sent a representative to testify in Washington. I appeared on this subject before the Estate and Gift Tax Subcommittee of the Senate on November 4, 1981, at the request of the Probate Committee of the Boston Bar Association. I now appear not only on the unanimous request of the Probate Committee, but on the unanimous request of the Council, the governing body of the Association.

It will come as no surprise to you that we urge immediate repeal of the present Chapter 13. In requesting repeal of present Chapter 13 we are aligned with all voices on this subject, including Treasury, whose April 29, 1983, proposal submitted to the Senate Finance Subcommittee on Estate and Gift Taxation describes Chapter 13 as likely to produce a high level of inadvertent non-compliance and uneven application; as being extremely complex; calling for compliance which would be costly; administration which would be unduly complex; requiring data difficult to obtain

and storage and retrieval of which would be extremely costly; not an effective tax; not fair; and not logically consistent.

The question then is what is to be done if Chapter 13 is repealed. There are two specific proposals before the Committee today, a Treasury Discussion Draft and an American Law Institute Discussion Draft. And presumably the Committee is open to consideration of other approaches.

The interest of the Boston Bar Association is, if there is to be a generation skipping transfer tax, that it be simple, understandable, capable of even application and enforcement, and not unduly burdensome in record keeping, planning and compliance requirements.

The two proposals currently before you, Treasury and ALI, are both improvements in terms of simplicity over present Chapter 13. The Association has not had the time to study them in detail or to take formal organizational action. We do believe, however, that there are remaining problems with both. I am authorized to outline our general views and to indicate other possible approaches to a generation skipping transfer tax, if the Committee remains of the view that such a tax is desirable.

First, the Treasury draft appears to offer some advantages over ALI in simplicity and reduction of burden upon the average lawyer and average trust. The Treasury exemption approach allows the smaller trust to be excluded from operation of the rules, thus freeing most lawyers and most trusts from the need for expensive compliance, record keeping and planning activities. The ALI credit approach means that every trust is potentially subject to the tax if it has good fortune in appreciation of assets, so that every trust technically must maintain full recordkeeping. In our view this is a less desirable and more complicated approach.

However, we must point out to you that adoption of the present Treasury draft would in our opinion result in a substantial increase in the establishment of generation skipping trusts, and a reduction in estate and gift tax collection, over what would occur in the absence of any generation skipping transfer tax at all. Once enacted, the bank trust departments, financial planners, lawyers and others will be aggressively marketing and advising establishment of million dollar generation skipping trusts, forever exempt from the tax no matter how long or for how many generations the trusts continue. People who otherwise would have the good sense not to enter into any such arrangement will have their judgment and decisions colored by what will seem to be an opportunity created for them to take advantage of. Mind you, these are people who under pre 1976 rules would not have gone beyond normal family dispositions.

If generation skipping is determined to be a problem against which action should be taken, we urge consideration of a simpler, more easily enforced and collected, and less administratively burdensome solution than either of the current proposals.

We suggest for consideration one approach which may meet these objectives. If it is thought that the pre 1976 laws offer a tax bias in favor of generation skipping, then this could be balanced by a tax incentive in favor of non-generation skipping transfers, namely, a credit or rate reduction for all non-skipping transfers. This would restore any alleged imbalance and would encourage outright dispositions, which would then be subject to full death tax or gift tax when passing from the hands of the donee.

A variant of this approach would be to combine it with a surtax or a rate increase on generation skipping transfers, or to use solely and increased tax, measured as of the transferor's date of death or date of gift, on offending transfers.

This approach would be simple, and would serve the principal purpose of encouraging non-skipping transfers. Treasury examiners could be fully trained to review and enforce the necessary calculations on estate tax or gift tax audit. The tax determination and payment would be upfront, tax neutral as between trust gifts and direct gifts, and no extended tracking would be necessary.

Some of us have asked a Special Subcommittee, composed of Professor David Westfall, William D. Kirchick, Esquire, and Wilson C. Piper, Esquire, to consider such a proposal and to draft. I am pleased to be able to submit the subcommittee draft, with this statement, for your consideration. Because of the time involved this proposal has not been examined and voted upon by the full Probate Committee or the Council, and the subcommittee itself has purposely refrained from making any recommendations about specific levels of exemption, increases in rates or deduction amounts. I think it important, however, to present its theory to you as a possible simpler, effective approach, if there is to be a generation skipping tax.

We urge that in the details of drafting any proposal, if there is to be a skipping tax, normal family dispositions, not motivated by tax avoidance concerns, be exempted, as follows:

First, where there is no person alive in the intervening generation. For example, a trust for the benefit of my children until the youngest is age 25, at which time principal goes to my then living children and to the issue of any deceased child. One of my children dies before the youngest reaches age 25 and is survived by a son, my grandchild. This orphaned grandchild presumably will have greater need and should receive more consideration. Why should this orphaned grandchild have to bear the burden of the additional skipping tax?

Second, a trust is sometimes advisable for protection purposes. Suppose a child of mine has an unfortunate history of alcoholism, retardation, or difficult marital problems. A trust for protection purposes is a normal drafting technique, with remaining principal on the child's death to go to that child's children if any. Should not these normal protective dispositions be insulated from the generation skipping transfer tax? Is not the easiest way to do that to exempt all trust which skip only one generation?

Third, there is the matter of the non-related person. If the drafting is in terms of requiring either benefits to or at least the existence of an intervening generation before the tax applies, then a transfer to a non-related person would not be subject to the tax. This seems appropriate. Suppose I have no immediate family and I want to leave money to young people, perhaps distant relations, perhaps not related at all but chosen solely on merit. Why should the extra tax apply, when there was never any possibility or intention of passing the funds through an intermediate generation? There is certainly no avoidance involved. Why should there be an artificial "generation" requirement based on age differentials, requiring the extra tax?

I should point out to you that the object of my affection in my moneyed old age might be a young and attractive member of the opposite sex to whom I might want to leave a substantial part of my wealth. Certainly there is no generation skipping: she's not related to me, and I have no interest in her mother or father. Although I do find the fact that she's of a younger generation appealing, it is not for tax avoidance purposes. I should point out to you that if you do draft such an exemption there are those who will refer to it as the "chorus girl exemption", or, in these days of equal treatment, the "chorus boy benefit". No doubt they will argue, they should these people be favored with a lower tax than my own grandchildren? But balancing these questions in one of the problems which must be faced if the Committee maintains its wish grasp the nettle of action on generation skipping. It is our view that it is preferable to exclude the non-related person where there is no intervening generation.

We have some other general thoughts on drafting to offer for your consideration:

First, if we are in the generation skipping thicket, should there not be some consideration given to encouraging direct transfers to younger people, or encouraging distributions from trust principal to younger generation beneficiaries, by means of some reduction in tax burden or similar reward? Our thought here is that it may be important for capital use purposes to have funds available for the active entrepreneurial group which is able to take risks and start new businesses, and will find in that capital that means of producing additional wealth and additional jobs, as contrasted with what may be thought of as the necessarily more conservative, prudent investment policies to be followed by trustees operating under long term trust restrictions. This is something the Committee may well wish to consider.

Second, the question of the scale of the exemption is one for determination by this Committee and the Congress. If, as I expect, the real generation skipping occurs with the vast family fortunes, of which the Rockfellers are a notable example, then I suggest the appropriate exemption level should be somewhere in the 50 million dollar range. This would then impact upon and deter the family office running family affairs and finances over many generations without death tax intervention. It would also have the advantage of eliminating the inducement to establish generation skipping trusts which would be afforded by a lower level of exemption. As mentioned, promotions would be set in motion to advantage of a lower exemption level. A 50 million dollar level would be something the average taxpayer would not need to concern himself with. He could go ahead making his disposition plans and arrangements without worrying about generation skipping, just as most of us did under pre 1976 law. The high exemption level would have the additional advantage that most lawyers would not need to concern themselves with the matter in their active professional career, and in turn Treasury would not have to concern itself with broad scale enforcement and record keeping, but could limit itself to the few real cases.

If the Committee in its wisdom determines that the exemption level should be fixed at some lower amount, then we suggest a level of \$3,500,000 per donor. The Shoup and Jantscher studies, based on 1957 and 1959 federal estate and gifts tax

returns, group estates into small, medium and large categories. To the extent generation skipping was a problem at all, "large" estates were identified as the ones which make use of the device disproportionately. The threshold for "large" estate category in 1957 and 1959 terms was \$1,000,000. One million dollars of 1957-59 money represents approximately \$3,500,000 of 1984 dollars. For this reason we suggest that if there is to be such an exemption, it should be drawn at the counterpart of the large estate category in today's terms, namely \$3,500,000.

The reference to the Shoup and Jantscher studies of 1957 and 1959 estate and gift tax returns points up one problem with which the Committee is asked to grapple: namely, the basic information you are given and upon which you are asked to act is old and out of date. It is subject to varying interpretations in any event, one possible interpretation being that there was very little generation skipping back then, that it was surprising it was so little taken advantage of, and that there was essentially no problem calling out for solution. Our view is that outside of the vast family fortunes, say \$50,000,000 or more, there is very little generation skipping undertaken for tax avoidance purposes. For those who did elect to skip under pre 1976 rules, there was a substantial trade off. Assets were placed in the relatively sterile hands of the professional trustee, and the intervening generation or generations were in essence deprived of independence, initiative and the opportunity to make their own decisions, both good and bad. Most testators and donors were keenly aware of the trade off and under pre 1976 rules wanted the funds to go to their children outright at an appropriate age, barring need for special protection. The recent increased exemptions and decreased rates work in the same direction: smaller estates are free to consider nothing but appropriate family dispositions, for non-tax related purposes.

Our experience in wrestling with the generation skipping problems leads us to believe that the complexity, the inequities and imbalances introduced by almost any possible solution outweigh any good to be obtained. We believe that current statistics would show that tax avoidance generation skipping is not a problem. We believe further that the supposed remedies will create a worse situation than the problem they are designed to cure. We, as the nation's first line tax collectors, want to have a workable, understandable tax system under which we can operate to produce the tax revenues needed by our country. We believe that the pursuit of an illusory goal of perfect equity or perfect fairness can be destructive to the tax system itself, as the scholar Aylmer's desire to remove a perceived flaw in his wife's beauty was fatal, to both her beauty and her life, in Nathaniel Hawthorne's *The "Birthmark"*.

[Memorandum]

To: Honorable Dan Rostenkowski, Chairman, Committee on Ways and Means, U.S. House of Representatives.

From: The Special Committee on Generation-Skipping of the Boston Bar Association.

Re A Simplified Alternative Method to Tax Generation-Skipping Transfers.

Date: September 28, 1984.

A. SUMMARY

This memorandum describes a simplified alternative method to tax generation-skipping transfers under the existing estate and gift taxes by raising rates and allowing an offsetting deduction for transfers that do not involve generation-skipping.

B. DISCUSSION

Both the Treasury and the American Law Institute proposals are extremely complex ways to deal with generation-skipping. Both would retain a separate Chapter 13 in the Code, imposing a new tax and forcing practitioners to learn and work with many unfamiliar terms, such as "non-trust direct skip" or "non-owned trust." Imposing a new tax also requires amendments of a host of related Code provisions, such as those dealing with alternative valuation, basis, income in respect of a decedent, and stock redemptions.

Introducing these complexities into the Code might be justified if there were no other way to deal with generation-skipping. In fact, however, a far simpler and more understandable alternative is at hand: An increase in estate and gift tax rates for transfers over a specified amount, offset by a partial deduction for such transfers as do not involve generation-skipping. The end result would leave present rates in effect for all transfers that qualified for the partial deduction.

To qualify for the deduction, (referred to in this memorandum as the "nonmarital deduction"), the transferor would be required to give the transferee the kind of in-

terest that would qualify for the marital deduction if the gift were to a spouse. The transferred property would then be subject to gift tax or estate tax (if not otherwise exempt) when the transferee's interest ended. Other kinds of interest might also be allowed to qualify for the deduction, with appropriate provisions to insure similar tax treatment on their termination.

By providing an easily understood incentive for transferors to forego the potential tax savings from generation-skipping, this approach would allow practitioners to work with familiar concepts based on the marital deduction. No one would need to master a new chapter of the Internal Revenue Code.

Part C of this memorandum shows in concrete terms how the proposal could be implemented and Part D describes changes in relevant Code provisions to carry it out. Finally, Part E seeks to anticipate and respond to arguments that may be made in opposition to the proposal.

C. IMPLEMENTATION AND EXAMPLES

To illustrate the operation of the proposal, it is necessary to deal with several important issues it raises: (1) The amount of increase in estate and gift tax rates (and an offsetting nonmarital deduction) and the level at which the increase would start; (2) the persons to whom qualifying transfers could be made; and (3) the kinds of interests that would qualify for the nonmarital deduction.

The following discussion suggests possible ways these issues might be resolved and illustrates how their resolution could affect the proposal's impact on taxpayers.

Changes could be made in other Code provisions as well. For example, the maximum credit for state death taxes could be increased for estates which fail to qualify for the maximum allowable nonmarital deduction. But it is submitted that such changes should be kept to a minimum, in order to minimize the kind of complexities the proposal seeks to avoid.

1. Amount of increase in tax rates (and an offsetting nonmarital deduction)

It is assumed here that the exemption from generation-skipping taxes proposed by the Treasury (\$1 million) would be reflected in the rate schedule, in that estate and gift tax rates would only go up for amounts in excess of \$1 million. The amount of the rate increase should take into account various factors, including the following:

(a) In order to achieve the simplification made possible by imposing the increased tax when the initial transfer is made, rather than when generation-skipping actually occurs, it is necessary to use an approximation, rather than seeking to tailor the tax in each instance to the precise amount otherwise payable.

(b) Transfers that fail to qualify for the proposed nonmarital deduction may result in generation-skipping with respect to varying portions of the property transferred. In some instances, all income of a trust may be accumulated for grandchildren or great-grandchildren, and the entire income and remainder interest may skip the children's generation. In other cases the trustee may exercise a discretionary power to distribute all of the income and principal to the children, so that nothing remains for later generations and no generation-skipping occurs. Doubtless the majority of cases would fall between the two extremes, so that generation-skipping occurs as to some, but not all, of the income and remainder interests in the property transferred.

(c) Some generation-skipping transfers may skip two generations, rather than one, typically by allowing property to pass to great-grandchildren of the transferor. It is submitted, however, that such double generation-skipping is relatively rare in practice.

This memorandum will not address the question of what increase in present estate and gift taxes would be appropriate to deal with generation-skipping, in the light of these and other relevant factors. We have assumed here and in part D of this memorandum, for purposes of illustration, that the rate schedule for amounts in excess of \$1 million would be increased 25%. Under these assumptions, the nonmarital deduction would be limited to the lesser of (a) 20% of qualifying transfers or (b) 20% of the taxable estate in excess of \$1 million. Corresponding adjustments in the size of each rate bracket would also be needed in order to keep the tax payable on qualifying transfers the same as under present law.

These hypothetical assumptions are reflected in the following table:

	Marginal rate (percent)
Present rate brackets:	
\$1,000,000 to \$1,250,000.....	41
\$1,250,000 to \$1,500,000.....	43
\$1,500,000 to \$2,000,000.....	45
\$2,000,000 to \$2,500,000.....	49
\$2,500,000 to \$3,000,000.....	53
Over \$3,000,000.....	55
Proposed rate brackets:	
\$1,000,000 to \$1,200,000.....	51.25
\$1,200,000 to \$1,400,000.....	53.75
\$1,400,000 to \$1,800,000.....	56.25
\$1,800,000 to \$2,200,000.....	61.25
\$2,200,000 to \$2,600,000.....	66.25
Over \$2,600,000.....	68.75

The result of the proposed changes would be that an individual with a taxable estate of \$2 million who now pays a tax of \$780,800 (before reduction for the unified credit and other credits) would pay the same tax if \$1 million of his transfers qualified for the nonmarital deduction, computed as follows:

Taxable estate.....	\$2,000,000
20 percent nonmarital deduction (based on 20 percent of the lesser of (a) qualifying transfers or (b) taxable estate in excess of \$1,000,000.....)	200,000
Net taxable estate.....	1,800,000
Estate tax on \$1,000,000, at present rates.....	345,800
Estate tax on next \$800,000, at proposed rates.....	435,000
Total estate tax.....	780,800

This follows from the fact that a tax at 125% of present rates on 80% of transferred property is equal to a tax at present rates on 100% of transferred property, if in the first instance, the brackets are reduced by 20% to preserve the degree of progression in the rate schedule contained in present law.

If the transferor failed to qualify for the nonmarital deduction, his estate tax would increase by \$122,500 to \$903,300, rather than the \$780,800 provided by present law. Thus, the 25% increase in rates, in conjunction with the narrowing of rate brackets (which is required in order to make the tax for transferors under the proposal who make full use of the nonmarital deduction the same as the tax under the present law), would result in a tax increase slightly in excess of 25% for the portion of gifts and estates over \$1 million, for transferors who failed to qualify for the nonmarital deduction under the proposal.

2. Persons to whom qualifying transfers could be made

The major classes of transferees to whom transfers might be allowed to qualify for the nonmarital deduction are: (a) Persons in the same generation, or a higher generation, than the transferor; (b) persons who are one generation below the transferor without regard to their relationship to him; and (c) grandchildren of the transferor who are offspring of a child who is deceased when the transfer is made.

Transferees described in (a) and (b) do not involve generation-skipping. The more debatable category is (c). Justification for allowing grandchildren described in (c) to qualify may be found in the fact that the transferor did not have the option to avoid the increased rates by making a transfer to the parent who might in turn have passed wealth on to the grandchildren free of transfer tax through the use of his own unified credit and present interest exclusion.

For purposes of determining whether or not a transfer qualifies, the interests of transferees in the same or a higher generation level than that of the transferor should be ignored.

3. The kinds of interests that would qualify

The proposal could readily be implemented by allowing a partial nonmarital deduction for the kinds of interests that would qualify for the marital deduction if the

transferee were the spouse of the transferor. Such interests cause the transferred property to be potentially subject to gift tax, if the transferee's interest end during her life, or to estate tax, if her interest does not end until her death, and thus carry out the purpose of a tax on generation-skipping transfers.

The question to be resolved is whether the class of interests qualifying for the marital deduction should be supplemented for purposes of this proposal by including other interests which serve legitimate estate planning objectives and do not result in significant avoidance of transfer taxes. For example, present law requires that to qualify for the marital deduction, a transfer in trust for a spouse must fit one of the following forms: (a) The power of appointment exception to the terminable interest rule, which requires that the spouse get income for life and a general power to appoint the property; (b) The QTIP trust also requiring income to the spouse for life, with inclusion of the trust property in her taxable estate when she dies; and (c) the little-used estate trust, for the exclusive benefit of the spouse and her estate.

The first two alternatives both require that the spouse be given all of the income. It may be desirable to allow departures from this requirement in qualifying for the nonmarital deduction in order to avoid forcing estate planning arrangements into a rigid mold. For example, the transferor may wish to give the trustee of a trust for his daughter, discretion to pay income or principal to his wife. As long as the daughter has the power to appoint whatever remains in the trust on her death (or is treated as if she had transferred the property at that time, as in the QTIP trust), there appears to be no generation-skipping in the arrangement and the nonmarital deduction should be allowed. Any income or principal distributed to the transferor's spouse that she does not consume or give away during her life will be includible in her taxable estate when she dies.

Similarly, the transferor may wish to create a single trust for his children, giving the trustee discretion to make distributions of income and principal to one or more of them from time to time, rather than establishing a separate trust for each child. The nonmarital deduction could be so structured as to allow the trust to qualify, if provisions were included to insure that a transfer potentially subject to gift tax or estate tax would occur whenever trust property was distributed, either during the continuance of the trust or upon its termination, to grandchildren or others more than one generation below that of the transferor. This could be accomplished by requiring that the trust property held for the children be subject to the exercise of a general power of appointment by child.

Again, the precise boundaries to be drawn in determining what kinds of interests should qualify for the nonmarital deduction can be resolved in a variety of ways without affecting the soundness of the principle embodied in this approach to be the problem of generation-skipping.

D. CHANGES IN CODE PROVISIONS

This Part discusses first the Code provisions which would need to be changed to carry out the basic principles of the proposal, and then deals with whether other Code provisions affected by the proposal would require revision for that reason.

1. Code Provisions Requiring Revision

Chapter 11—Estate Tax

§ 2001(c) Rate Schedule.—Rates in excess of [\$1 million] would be increased to [25%] and brackets reduced [20%] in order to retain the degree of progression under the present schedule for estates qualifying for the partial nonmarital deduction.

§ 2044 Certain Property for Which Marital Deduction Was Previously Allowed.—This section would be broadened to refer as well to the nonmarital deduction, so that if a partial deduction had been allowed for property not otherwise includible in the transferee's estate, such as a QTIP trust, the full value of the trust property would be includible.

§ 2057 Bequests to Persons Other than the Surviving Spouse.—This section would allow a partial deduction for transfers to qualifying transferees (other than the surviving spouse). The deduction would be limited to a percentage of the portion of the taxable estate that exceeds a specified amount, such as the \$1 million in the Treasury proposal. The section would specify the kinds of interests that could qualify for the deduction, including those specified in § 2056 for marital deduction bequests and any others that might be added to the list, to insure fairness in treatment.

Chapter 12—Gift Tax

§ 2519 Disposition of Certain Life Estates.—This section would be broadened to refer as well to the non-marital deduction, so that if a partial deduction had been allowed for property not otherwise includible in a donor's gifts, such as a QTIP trust, the full value of the trust property would be includible if the donor's income interest was disposed of.

§§ 2524-2525.—Present § 2524 should be renumbered as § 2525 and broadened to refer to Gifts to Persons Other than a Spouse. Section 2524 should allow a partial deduction for transfers to qualifying transferees (other than a spouse). The deduction would be limited to a percentage of gifts exceeding a specified amount, such as the \$1 million in the Treasury proposal. The section would specify the kinds of interests that could qualify for the deduction, including those specified in § 2056 for marital deduction bequests and any others that might be added to the list.

Chapter 13—Tax on Generation-Skipping Transfers

This chapter should be repealed.

2. Code provisions affected by the proposal but not necessarily requiring revision

Generally the proposal requires no changes in other Code provisions dealing with estate and gift taxes because no separate new tax is imposed. Existing provisions would apply to increased estate and gift taxes collected on transfers which failed to qualify for the nonmarital deduction. This would be true for provisions dealing with alternate valuation, basis, gift-splitting by married persons, income in respect of a decedent, stock redemptions, and installment payment of estate taxes.

The only Code provision affected by the proposal which arguably requires revision is § 2011, dealing with the credit for state death taxes, which could be revised to reflect the increased estate tax rates. Whether or not this form of revenue sharing is desirable is a policy question on which opinions may differ.

E. POSSIBLE ARGUMENTS IN OPPOSITION TO THE PROPOSAL

Proponents of the Treasury and ALI drafts may advance the following arguments in opposition to the proposal:

(1) Taxing transfers when made, rather than when the property actually passes to younger generation beneficiaries, is likely to produce a tax that is either too high or too low in relation to the amount of wealth that actually skips a generation.

The proposal necessarily uses an approximation, which could be based on averages, in order to allow tax liability to be determined earlier, rather than later. However, this kind of approximation is extensively used elsewhere in the transfer tax system—for example, in valuing life estates and remainders. The administrative convenience for taxpayers, practitioners, fiduciaries, and the service far outweighs the loss of precision in computing the tax.

(2) Property transferred under a generation-skipping arrangement may appreciate, either as a result of natural economic forces or because the transferor gives an equity interest in an enterprise and then finds ways to enhance the value of that interest through his personal efforts or the use of his other assets for less than fair market value.

Similar problems arise in the valuation of property for gift tax purposes at the time of the transfer, rather than on the death of the transferor. Any donated asset may either appreciate or depreciate in value. Appreciation that results from uncompensated (or undercompensated) services of the donor ordinarily is not within the scope of the transfer taxes, which apply to the transfer of *property*. Appreciation that results from the use of other assets of the transferor for less than fair market value may be treated as a separate transfer for tax purposes as in the case of interest-free loans.

(3) Generation-skipping arrangements may continue indefinitely in Wisconsin and any other states that do not apply the Rule Against Perpetuities to non-charitable trusts if the trustee has a power of sale.

Existing estate and gift tax provisions dealing with powers of appointment address the problem of state-law variations permitting an extension of the perpetuities period, and thus the period of possible generation-skipping. See §§ 2041(a)(3), 2514(d). These provisions, which were enacted in response to the Delaware statute dealing with special powers of appointment, merit reexamination both in relation to Delaware and to Wisconsin. In their present form, the sections do not prevent an indefinite generation-skipping arrangement under Wisconsin law. See *Estate of Mary T. Murphy* 71 T.C. 671 (1979), acq. 1979-1 Cum. Bul. 1. However, it would be far better

to revise the present estate and gift tax provisions to keep state-law aberrations with respect to perpetuities from creating opportunities for tax avoidance, rather than burdening taxpayers in other states with a new tax to deal with.

(4) It is fairer to tax generation-skipping transfers as they occur, rather than to assess tax on a transfer when it is made even though it does not result in generation-skipping.

Taxpayers have the option of avoiding the result by qualifying for the nonmarital deduction.

STATEMENT OF FRANK S. BERALL, CHAIRMAN, ESTATES AND PROBATE SECTION, CONNECTICUT BAR ASSOCIATION

Mr. BERALL. I am Frank Berall of Hartford, CT, chairman of the estates and probate section of the Connecticut Bar Association, and former chairman of its tax section. I represent the Connecticut Bar Association.

Let me say on behalf of the association that we sincerely appreciate the privilege of appearing before you to assist in solving the problems of the generation-skipping tax.

There is no real need for me to dwell on the reasons why we think that the present unsatisfactory generation-skipping transfer tax should be retroactively repealed. Everyone, including the Treasury, also thinks it should be retroactively repealed. The main issue is how to replace it without introducing a substitute which is nearly as complex and as hard to administer as the present tax.

We have looked at the two bills and their summaries, and we believe that both of them are still too complex and will affect too many people. Worse yet, the most serious objection to both of their approaches is that they introduce the principle of taxing direct skips, where the skipped generation receives no benefits and may even have died before the skip occurs.

If the Treasury approach is going to be enacted in a replacement tax, than at a minimum, we recommend an exemption level of \$2.5 million. We do not favor the credit approach of the ALI, and we believe that the tax computation should be made on a tax-exclusive basis, like the gift tax.

Transfers occurring as a result of a direct skip should not be taxed at all, or at only a fraction of the rate on other transfers if you believe there is a policy reason to tax them, and then a direct skip should be taxed only if there is a living ancestor of the transferee in a lower generation from that of the transferor at the time of the transfer.

Income distributions should not be taxed. The tax should be prospective, with retroactive repeal of the present tax. But we have an alternative proposal for your consideration. It is an entirely new approach; a wraparound accessions tax. It would wrap around the existing estate and gift taxes to supplement them, in lieu of the present generation-skipping transfer tax.

An accessions tax in its broadest sense is an excise on the receipt of any transferred property, graduated according to the recipients' cumulative lifetime total of accessions from all sources. A wrap-around accessions tax would tax only those accessions that arise as the result of a generation-skipping transfer and not change the estate and gift tax structure.

The tax would be collected from the recipients; the accessionees of the transfers. It would be based on the total of all other taxable

generation-skipping transfers they have previously received as accessions. It would be imposed for the year in which one or more accessions actually vested in an accessioneer, rather than at the time of creating a trust.

An accessions tax of this nature may bear more heavily than a transfer tax on the accessions of a single person who has his accessions from several sources and it may bear less heavily on the division of a single estate among several recipients who have no accessions from other sources.

Besides taxing at the time of vesting, accessions that have skipped one or more generations, you could add to the accessions tax a supplement in the form of a tax on the corpus of a long-term trust, if this is deemed necessary to prevent avoidance, although it will add a little complexity. The accessions tax would be simpler without adding it.

Retroactive repeal and replacement of the generation-skipping tax by an accessions tax on all generation-skipping transfers should not include the taxation of direct skips. However, if you are going to tax these anyway, then you should only do so when someone in an intervening generation is living at the time of the transfer, and then at only half the rate.

We also suggest a \$10,000 annual exclusion for each accessioneer. An exemption equivalent to the credit against the unified gift and estate taxes for each accessioneer could also be used against his or her cumulative accessions before any tax would be due. Thus, you would first have it used against accessions, then gifts, and, after the accessioneer has died, his or her estate.

This would merely require another line on the income tax return to ask if any taxable accessions—with reference to a definition in the instructions—have been received during the year.

If so, you would request that an additional schedule, called an accessions tax schedule be filed with the necessary information. Trustees would file information returns in the year of distributions of corpus or income to an accessioneer.

We think that a wraparound accessions tax, by eliminating the concept of a deemed transferor and some of the other problems of the existing chapter 13 tax, as well as the problems in the two proposed tax bills, would greatly simplify the taxation of generation-skipping transfers at a minimal administrative cost to the Service and to taxpayers. At the same time it will prevent nearly all of the tax avoidance for which there seems to be a consensus that we need some form of generation-skipping transfer tax.

On behalf of the Connecticut Bar Association, thank you for the opportunity to testify. We wish to express our willingness to participate with this committee and the other tax-writing committee staffs in a collegial effort to deal with the generation-skipping transfer tax, either with an accessions tax or through some other means.

[The prepared statement follows:]

STATEMENT OF FRANK S. BERALL, CHAIRMAN, ESTATES AND PROBATE SECTION,
CONNECTICUT BAR ASSOCIATION

This statement is the official position of the Connecticut Bar Association which I am making in my capacity as Chairman of its Estates and Probate Section. We are a professional organization of more than 7,900 (out of a possible 10,000) lawyers admitted to practice in Connecticut.

I. OUTLINE SUMMARIZING MAIN POINTS AND SYNOPSIS OF
CONTENTS OF STATEMENT

This testimony first sets forth our qualifications for commenting on this subject, followed by:

(A) Our reasons for urging retroactive repeal of the present Generation Skipping Transfer Tax;

(B) Detailed comments as to why neither the alternative advocated by the Treasury (H.R.6260) nor that of the American Law Institute (H.R.6261) is an entirely satisfactory solution to the problem of taxing generation skipping transfers, since each is far too complex and would tax direct skips;

(C) A modification of the Treasury's approach as another possible alternative;

(D) Discussion of an entirely different approach to the taxation of generation-skipping transfers; namely a wraparound

accessions tax which would supplement the existing gift and estate taxes;

(E) Discussion of other types of accessions tax alternatives described in appendices (2) and (3).

II. Qualifications of the Preparers of the Connecticut Bar Association's Testimony

The lawyers who prepared this testimony, members of our Estates and Probate Section, have all had substantial experience in planning and administering estates under the present Generation Skipping Transfer Tax, most as attorneys for fiduciaries and some as bank trust department executives.

III. Testimony

A. Reasons for Retroactive Repeal of the Present Generation Skipping Transfer Tax

Testimony presented by the American Bar Association and The American College of Probate Counsel, as well as other groups has ably set forth in detail why the present Generation Skipping Transfer Tax should be repealed. The Connecticut Bar Association endorses their views, pointing out that even the Treasury concedes that the present generation-skipping transfer tax is unworkable, unenforceable and not producing any real revenue. Besides being a trap for the unwary it is far too complex.

The tax leads to inadvertent non-compliance, is an administrative nightmare for the Internal Revenue Service, can be readily, albeit expensively avoided, is unfair because of

its complexity and ineffectiveness and is not based on any logically consistent view of the transfer tax system. Nevertheless, the mere fact of its existence has required a substantial amount of time and effort to be spent by many members of the probate and tax bar, the trust departments of most banks and the Internal Revenue Service. They must study the tax, keep their knowledge current, and (except for the Internal Revenue Service) need to consider its potential consequences in planning medium and large size estates and in drafting instruments to implement these plans, where conventional family trust provisions are desired by their owners.

As a result, the cost of estate planning and drafting trusts and wills is unnecessarily increased. Additional complexities must be introduced into many instruments to eliminate or at least minimize the possibility that a generation skipping transfer tax may be incurred if an unusual order of deaths or other unexpected events occur. Therefore, this tax should be retroactively repealed.

B. Analysis of the Treasury's and American Law Institute's
Proposals

1. General comments

a. We oppose a tax on direct skips

Both the Treasury and ALI proposals would tax every direct transfer (sometimes referred to as a direct skip) to a person more removed than one generation from the transferor. A common disposition used in even the simplest wills provides for distribution to "issue per stirpes". Under these

proposals, every such disposition has the potential for producing a generation skipping transfer. Most people would not consider such a disposition to be a transfer intended to skip generations. In fact, this transfer cannot reach a remote generation unless the intermediate generation has died.

For example, a disposition of this type by a transferor who had three children, one of whom has predeceased him, would have the deceased child's share pass to the deceased child's children (grandchildren of the transferor). This would attract a generation skipping tax. Either direct transfers should be excluded from the tax base or an exception should be made where a transfer passes directly to a transferee with no living ancestor in a generation between that of the transferor and the transferee. In any case, the tax rate on a direct skip should be no more than half of that otherwise imposed.

b. Return filing problems

Neither proposal seems to contain any provisions as to when returns are required, leaving it to the Secretary to issue rules. Under the Treasury proposal, unless returns are required in every case, no matter how small the transfer, it could be administratively impossible to keep track of the use of exemptions. This is probably true to a lesser extent under the ALI approach, because of the use of the credit. If returns are going to be required for all generation skipping transfers, it would seem that a tremendous burden would be imposed upon taxpayers and the Internal Revenue Service, particularly if direct skips are included.

c. Determining the threshold for the exemption

Another basic problem with both of the proposals is that a determination has to be made by a trustee as to when the million dollar threshold is reached. However, while the burden that both of them impose on the trustee is still the same, the amount of filing is reduced over what the present law requires. On the other hand, the wraparound accessions tax we propose (in Part D, below), including (if deemed necessary) a flat tax on distributions from a trust, is a far simpler system for a trustee to administer. Yet it seems to accomplish the same purpose.

d. Records

In general, the less one taxpayer's tax liability is dependent upon the records and tax returns of another taxpayer, the more manageable the tax return requirements will be. It is well known that taxpayers have difficulty preserving their own records and the Internal Revenue Service has difficulty producing filed returns. Therefore, any system which relies on the sharing of tax exemptions and credits is necessarily frustrating.

e. Two-taxable events

Both proposals would reduce the number of taxable events from three to two in the case of long term trusts which provide for two generations of income beneficiaries, with distribution of corpus to the third generation. This may be the tax price that has to be paid to simplify the present Generation Skipping Transfer Tax law to remove the concept of a "deemed transferor". This price is cheap and the decision wise. The number of transferors willing to tie up property in

trust for two full generations after their death should be few, in spite of this apparent incentive, so the tax loss should be small. The benefit of the change however is substantial if simplicity and workability are important tax writing goals. The deemed transferor under present law is a make believe concept, with all the weight on the "deemed" and no reality to the "transferor". To eliminate it is to take a long step toward simplifying what will still remain an abstruse piece of tax law.

f. Credit versus exemption

The Treasury's exemption proposal is superior to the ALI credit for two reasons. First it is simpler. The up-front identification of a trust as a generation skipping trust will be of great value in avoiding the pitfalls of this tax. Secondly, it is equitable to have asset appreciation escape tax in trusts under \$1,000,000. Inflation has been the engine driving most transfer taxes in this century, and it will likely continue. If trusts that start relatively small avoid later tax as they grow, whether from inflation or otherwise, this is worth the great cumulative relief that will accrue to trustees and beneficiaries of exempted trusts from the knowledge that they are outside of the Generation Skipping Transfer Tax thicket.

One of the prime objectives of the Congress in replacing the present tax should be to free as many taxpayers and advisors as possible from the purview of the tax; consistent, of course, with the policy of the legislation. While we urge a higher exemption, at least the exemption concept goes some

distance toward properly limiting the number of trusts and direct transfers that will be the target of a generation skipping tax.

g. Transferability

Transferability of the exemption is sensible in the context of free inter-spousal transfers. While it will add complexity to the law, it would be inconsistent with the present theory of transfer taxation to omit it.

h. Annual distribution exemption

We disagree with the premise that gives rise to the need for an annual exemption; the premise that income distributions are generation skipping transfers. In our opinion, the income tax of trust beneficiaries should stand alone. Acknowledging the existence of the transfer tax problem sought to be addressed here and the credit against income tax offered, the interests of simplicity are not well served by applying the Generation Skipping Transfer Tax to payments of income, then allowing an annual credit to let de minimis transfers through.

i. Weakness of present tax and the two proposals

This basic principle seems to us to define the central weakness of the present generation skipping tax law and both the Treasury and ALI proposals. A tax assessed on the persons who receive the property - an "accessions tax" - seems to us to be the only system that will work.

2. Specific issues on which public comment is requested

The Treasury proposal is somewhat less complex than that of the ALI, in the sense of determining tax liability. Thus it is more straightforward in that respect. Furthermore,

while under present law the trustee has a reporting obligation only with respect to taxable distributions, as distinct from taxable terminations, under the ALI proposal it would appear that the trustee will also have the responsibility for reporting taxable terminations.

a. Trusts which provide for more than one younger generation

To be consistent with the principle of taxing each transfer between generations, a trust which provides for more than one younger generation should be taxed as it passes from level to level. On the other hand, so long as property remains in trust, the beneficiaries are deprived of the benefit of absolute ownership. It is reasonable for the tax law to take this difference in enjoyment into consideration in limiting the reach of the generation skipping tax.

b. Credit versus exemption

As practitioners, we value the exemption approach because it eliminates immediately certain taxpayers for whom the cost of compliance would far exceed the potential benefit to the Treasury. For this same reason we believe that the exemption should be much higher than \$1,000,000. (Three million or at least \$2.5 million would not be inappropriate.) By contrast, the difficulties that various trustees could have in tracking use of a credit would outweigh many of the benefits of the tax. (In estates which exceed the exemption, the trustees would experience the same information-gathering problem; see our General Comment, #1 above.)

c. Transferability

Transferability comes very close to creating a property

interest in a tax credit or exemption, which could have all sorts of inappropriate implications (such as in divorce). We prefer to see no credit or exemption which relies for its determination on the tax records of anyone other than the immediate transferor, or better yet, the recipient.

d. Annual exemption

The record keeping required to establish the exemption is no less onerous than that required to determine the tax. Nevertheless, we are in favor of establishing a high threshold for the tax and then applying it to every transaction over that threshold. If we allow small exemptions, practitioners will spend an inordinate amount of time creating ways to maximize all possible exemptions.

e. Credit for state taxes

Simplicity would suggest that there should be no credit. On the other hand, there is ample precedent in the estate tax and income tax areas for the federal government to acknowledge the tax burden imposed by a taxpayer's state. The credit should be available for this reason, regardless of the indirect revenue sharing effects.

3. Specific Comments on Treasury Proposals

Taxable terminations are fraught with difficulties and complications. Under the Trasury proposal a taxable termination occurs when all interests of non-skipped persons have expired. If this were adopted in its present form, all trusts would be drafted so as to include contingent interests, no matter how remote, in persons in a non-skipped generation. The result would impose an impossible burden on the trustee to

keep track of such interests and to determine when they have terminated. It would be much better to impose the tax only when the distribution is actually made to a "skipped person". For this purpose the approach of the accessions tax (described in Part D. below) would be far preferable.

4. Specific Comments on ALI Proposals

Imposition of a flat tax at such a high rate may create undue hardships in cases where there are legitimate non-tax reasons for generation skipping trusts. The concept of an "owned trust" does not resolve this problem because the powers required to be given to the beneficiary are inconsistent with many of the non-tax reasons for a generation skipping trust.

We would expect considerable public resistance to the concept of a surtax on direct skips, in addition to the gift tax already due on such transfers. The direct skip differs dramatically from a trust in which two generations benefit; the donor is making a substantial trade off for the ostensible tax advantages. The practical result of a surcharge might well be a reluctance to make direct skips in favor of postponing the tax, which would in turn cause more property to be tied up in trusts than is already the case.

The provisions for reallocating the transferor's generation skipping credit after his death presume an unrealistic degree of knowledge and cooperation among trustees. The lack of one authority to dictate allocation issues could leave the trustees with great uncertainty.

It is unfortunate that the laudable concept of preventing huge accumulations of wealth passing from generation to

generation cannot be tackled in a simpler manner. The ALI proposal to repeal the existing generation skipping tax law and substitute its version is little improvement over the existing law, because of its complexity.

There are approximately 60 references to other code sections and subchapters. If one expands the proposal and includes a study of the other code sections which qualify the proposal, the number of words needed to be studied, analyzed, and digested reaches astronomical proportions. The ALI proposal introduces new technical terms (non-owned trust, etc.), allocation and reallocation of certain credits and the tracking of the rates imposed on the estates of decedents who may have died sometime ago (i.e., more record keeping).

C. Suggested modifications to the Treasury Approach

The specific generation-skipping transfer tax exemption for every individual should be increased to at least \$2.5 million. The computation of the tax imposed on generation-skipping transfers should be made on a tax exclusive basis. The calculation should be identical to that performed in calculating the gift tax, as distinct from the tax inclusive type of calculation used for the estate tax. Transfers occurring as a result of a direct skip should be taxed at only a fraction (such as one half or less) of the tax rate on other generation-skipping transfers. However, transfers to a grandchild or more remote descendant should not be subject to a tax on direct skips, if there is no living ancestor of the transferee in a lower generation than that of the transferor at the time of the transfer. (Thus, a transfer

to a grandchild of the transferor would not be taxed if the child--the parent of the grandchild--is deceased.) The generation-skipping transfer tax rate could be imposed at the maximum marginal unified estate and gift tax transfer rate. Distributions of income should not be subject to the generation-skipping transfer tax. The tax would become effective prospectively, a year from the date of enactment, to be fair to people contemplating direct skip transfers who will need time to become aware of this change in the law. This means that there will not have been any generation-skipping transfer tax in effect up until that date.

D. An entirely new approach; the wraparound Accessions Tax

1. The basic concept of an accessions tax

The American Law Institute's original accessions tax proposal, contained in its 1969 Project on Federal Estate and Gift Taxation, pages 446-589, was principally the work of Professor William D. Andrews of the Harvard Law School, as Associate Reporter for the ALI. It points out that an accessions tax in its broadest sense is an excise or "transfer tax on the recipient of property transferred by gift, bequest, devise or inheritance, graduated according to the recipient's cumulative lifetime total of such accessions from all sources,"[p. 446] "rather than [a tax on] the donor or the decedent's estate." Andrews, "The Accessions Tax Proposal", 22 Tax L. Rev. 589 (1967).

The first description of an accessions tax in legal literature appears to have been done by Professor Harry Rudick in "A Proposal for an Accessions Tax," 1 Tax L. Rev. 25

(1945). This was supplemented, with some refinements, as part of a symposium; Rudick, "What Alternative to the Estate and Gift Taxes?", 38 Calif. L. Rev. 150 (1950) and Surrey, "An Introduction to Revision of the Federal Estate and Gift Taxes," 38 Calif. L. Rev. 1 (1950). It was followed by a critique of Rudick's plan, with additional elaborations by Kirshberg, "The Accessions Tax: Administrative Bramble Bush or Instrument of Social Policy?", 14 U.C.L.A. L. Rev. 135 (1966). References to an accessions tax or something akin to it also appear in economic literature, such as in Shoup, "Federal Estate and Gift Taxes" (1966). See Andrews, supra, 22 Tax L. Rev. 589, from which this paragraph has been excerpted.

Thus, an accessions tax is collected from recipients of property. Its amount is based on their circumstances rather than on those of donors and estates. It differs from an inheritance tax in that it is based on cumulative accessions received by the taxpayer from all sources over his entire lifetime. It is graduated accordingly and, furthermore, taxes accessions as the recipient obtains them, rather than at the time of creation of some future interest in a trust. (This paragraph has been paraphrased from a memorandum by Professor Edward Halbach of the University of California Law School.)

The graduated rate schedule of an accessions tax is based on the aggregate taxable accessions of the recipient from all sources, without regard to other property owned or disposed of by the donor or decedent. Thus, an accessions tax may bear more heavily than a transfer tax on the accessions of

a single person from several sources and less heavily on the division of a single estate among several recipients who have no accessions from other sources. An accessions tax differs from an estate tax in that the latter is an excise tax imposed on the transfer of property from a decedent, while an accessions tax is imposed on the receipt of property in vested form, either at death or at such later time as the property is ultimately distributed outright to its recipient. See Andrews, supra, 22 Tax L. Rev. 589.

2. Supplementing the estate and gift taxes with an accessions tax in lieu of a generation skipping tax

The Connecticut Bar Association is not advocating replacement of all of the existing wealth transfer taxes (the unified Gift and Estate Tax and the Generation Skipping Transfer Tax) by an accessions tax, as has been urged in the material referred to above. Considerable additional thought and study must be given before any suggestion should be made to replace the estate and gift taxes, which are generally working satisfactorily. However, we are suggesting that a modification of the accessions tax concept, which we are referring to here as a wraparound accessions tax (it would wrap around the present estate and gift taxes to supplement them, as does the present Generation Skipping Transfer Tax), be considered in lieu of the present Generation Skipping Transfer Tax and the Treasury and American Law Institute's proposals.

The proposed wraparound accessions tax is necessarily

only a partial hybrid accessions tax, since the only accessions it would tax are those which have skipped one or more generations before they vest. Additionally, in an attempt to discourage postponement of the tax through the use of long term trusts (particularly in states that no longer have a rule against perpetuities), consideration could be given to levying a supplemental tax on the trust corpus at an appropriate time.

We do not present this wraparound accessions tax proposal as one free from fault and ready for enactment. There has been insufficient time for enough lawyers to study and comment on this concept. If and when such additional consideration takes place, modifications of it will no doubt be made. Thus we have indicated alternative ways of handling the tax, to stimulate further thought by the tax writing committees of the Congress and the professional groups, as well as individual lawyers and others who may be examining this concept as a potential alternative (in addition to the Treasury's and American Law Institute's proposals) to the Generation Skipping Transfer Tax.

3. Nature and policy of the wraparound accessions tax

The generation skipping transfer tax would be retroactively repealed. It would be replaced by a tax on all accessions from such transfers. While we do not favor taxation of direct skips, if they are to be taxed this should be done only where someone in an intervening generation was living at the time of the transfer and then only at half the applicable rate.

We would adopt the generation assignments of the generation skipping tax, permit an annual exclusion of \$10,000 for all individuals receiving accessions, hereafter called "accessionees", and defined in substantially the same way as are deemed transferrees under the present generation skipping transfer tax. Thus (except for direct skips) wealth would be taxed at least once every generation. Therefore, the same policy as that of the present generation skipping transfer tax and the other two major proposed substitutes would still be implemented. If there is to be a tax on direct skips, it should be a modified one, somewhat less onerous than direct skip tax proposed by the Treasury or the ALI..

However, with one important exception (see paragraph 8, below) the tax, instead of being paid by the trustee or donor, would only be payable by an accessionee. The generational assignments of the present tax could be used.

4. Effective date

The proposed wraparound accessions tax should apply only to accessions received by transfers under instruments executed after its enactment date. It would even be desirable to delay the effective date for up to a year thereafter.

This delay, coupled with the retroactive elimination of any generation skipping transfer tax liability under the existing tax (in force since June 11, 1976), would give a period of time during which generation skipping transfers could be set up with impunity. Nonetheless, because of the long term nature of these transfers, it is better to allow some of them to escape during a hiatus between the effective

date of a law retroactively repealing the present Generation Skipping Transfer Tax and imposing a wraparound accessions tax, than it would be to enact an entirely new system without a reasonable opportunity for planning to adjust to it.

5. Mild rate progression and exemption

The accessions tax would be progressive, using the estate and gift tax rates. The existing estate and gift tax exemption equivalent to the unified credit could also apply to it so that an accessioneer's exemption would be applied against his* cumulative accessions received as well as any gifts made by him. Whatever was left at his death could be used against his estate tax liability. In addition, an accessioneer would receive separate \$10,000 annual exclusions both for his gifts and his accessions. Thus, when cumulative accessions from all sources (less annual exclusions) exceeds \$3 million, (following the effective date of an accessions tax), the marginal rate on the excess would be 55% until 1988 and 50% on the excess over \$2.5 million after 1987, when the top transfer tax rate phases down.

If higher rates are a political necessity, to obtain enactment of this proposal, then after computing a "tentative accessions tax", the actual tax liability could be set at 125% or some other appropriate higher percent of this tentative tax.

*Wherever the words "his", "he", "him", "man", "men" or comparable words or parts of words appear they have been used solely in the interest of having a smooth reading text. They are meant to be understood in their generic sense; to include all of mankind-whether male or female.

6. Due date, base for and events giving rise to tax: direct skips

The tax would be due at the same time as an accessioneer's federal income tax for the year in which the accessioneer actually received (had vested in himself outright) a generation skipping transfer. The value of an accession would be the actual cash or fair market value of property, whether corpus or income, distributed to the accessioneer on the date of distribution.

Only accessions vesting following the actual skipping of one or more older generations would be taxable. Thus, a remainder to a grandchild following a life income interest in trust or a legal life estate for a child would be a taxable accession at the time of distribution to the grandchild; the accessioneer.

We have serious reservations as to the fairness and appropriateness of taxing direct skips at all, since the intervening generation has no beneficial enjoyment of the property and a tax on direct transfers to grandchildren without the present \$250,000 grandchild exclusion would be far more oppressive than present law. But, while we do not advocate it, a direct transfer to a grandchild whose parent, aunt or uncle (the child of the transferor) was still living could be considered a taxable accession at the time of the transfer. If so, it should only be taxable at half rates.

Where such an outright transfer or a distribution from a trust to a grandchild occurred, this direct skip, if taxable at all, should only be taxable if a person in an intervening

generation was living either at the time of (a) the outright transfer or (b) the creation of a transfer in trust for a younger generation.

7. Credit or deduction for income tax but not for transfer taxes; stepped up basis

An accession could also be taxable as income (as determined under whatever Subchapter J rules are in force at the time of that accession). For example, this could occur where income distributions are made to a grandchild from a generation skipping trust set up at a time when the grandchild's parent was living. There should then either be a full or partial credit against the accessions tax for any income tax paid by the accessioneer on that particular accession or there should be a deduction from the income distribution for the accessions tax. Alternative ways of handling the interaction between the income and accessions taxes would be to credit (fully or partially) the accessions tax due on a given accession against any income tax attributable to that particular accession or provide for a deduction against that year's income of the accessioneer for the accessions tax paid.

There should be no credits for any gift taxes payable by the donor, because the gift tax is tax exclusive (computed on the net amount passing to the donee). Furthermore, while the estate tax is tax inclusive (based on the gross estate before tax) any deduction against the base for the accessions tax or credit against the tax itself for an allocable share of the estate tax paid by the estate of the creator of a generation

skipping transfer would run counter to a policy of taxing once each generation.

The basis of property received by an accessioneer should be stepped up to its value for accessions tax purposes.

8. Possible imposition of a supplemental flat tax on long term trusts

A wraparound accessions tax could be deferred (if not totally avoided in those jurisdictions which no longer have a rule against remoteness of vesting) by the use of long term trusts. Since the price of any such deferral or avoidance is delay or complete prevention of an accessioneer receiving benefits, this may be a sufficient deterrent to such trusts. If not if and when distribution of income is finally made the tax will reflect accretions to the trust.

Only if these two deterrents to using very long term trusts are considered insufficient, should consideration be given to imposing a flat tax on a generation skipping trust itself. (Consider some of the complications of the flat tax described in paragraph 9, below.)

If a supplemental flat tax is imposed, it would be due if there was no actual distribution to an accessioneer at the later of: (a) the death of a child of the settlor (the potential accessioneer's parent, aunt or uncle), or (b) 50 or some other appropriate number of years after the later of creation of the trust or the date of enactment of the tax. (A similar rule would then have to apply to property held in successive legal life estates.) This is equivalent to a federal rule against perpetuities. But, especially if less

than 50 years is used, the period during which property can be tied up without paying a tax is probably shorter than it would be under the common rule against perpetuities.

Such a flat tax would be due even if the child was neither an ancestor of any potential accessioneer nor a beneficiary of the trust. The trigger points should be easy for the trustee to determine (since his records would show the date of creation of the trust and he should become aware of the death of one of the settlor's children).

The tax is not directly on wealth held outright. It is on wealth which is slowly in transit between generations. Therefore, imposition of the tax every 50 (or other number of) years (if the settlor's children have died and no distribution has been made) should neither be a direct tax on wealth, which some scholars believe to be unconstitutional, nor a precedent for a wealth tax. Nevertheless, if a flat tax must be used, additional consideration may have to be given whether there should be an annual reduction of the tax base by an amount equivalent to an annual exclusion.

9. Non-refundable credit for flat tax

Where a flat tax has been paid by the trustee, then at the time of distribution of either income or corpus to an accessioneer, the latter would be entitled to a non-refundable credit against his accessions tax for his pro-rata share of up to the entire amount of the flat tax paid by the trustee. In computing this credit, the accessioneer would first reduce his accessions tax by any income tax payable by him from the accession.

Any unused income tax credit for an accession carrying out DNI (which could exceed the accessions tax due) would be carried forward against future accessions tax liability. Thereafter, the accessioneer would use the credit for the flat tax previously paid by the trustee against that and future accessions. In addition, the accessions tax credit could be used against any gift taxes actually due from the accessioneer and, to the extent that there was an unused accessions tax credit at the death of the accessioneer, it could also be used against any actual estate taxes due.

In the case of an accessioneer whose surviving spouse received a marital deduction share equal to or in excess of the base against which the accessions tax credit would have been credited, any unused accessions tax credit could pass to the surviving spouse, to be used against her future accessions, gift and estate taxes.

The first accessioneer receiving a distribution from the trust subject to the accessions tax would receive the benefit of the credit under a first in first out concept. This would permit a certain amount of planning with discretionary trusts, to allow the trustee to make a distribution carrying out the credit to a higher bracket accessioneer (because that person had received more accessions than other remaindermen of the trust) than to a low bracket accessioneer.

These complications (described in the above paragraphs of point 9) may outweigh any benefits from a flat tax.

10. Administration of the accessions tax and use of income tax returns to report it

Individual federal income tax return forms could have a one line question on the present page two, asking whether the taxpayer had received any accessions (with a cross reference to a brief definition of them in the instructions) after the effective date of the accessions tax. If he answered yes, instructions under that question could tell him to file an accessions tax schedule as part of his income tax return.

In any taxable year in which a taxpayer received no new accessions, this schedule would merely show the years and amounts of prior accessions and of the accessions tax (less any credits) paid on them. This would enable the taxpayer and the I.R.S. to have a permanent running record of all of his accessions. He could then refer to this when preparing subsequent federal income tax returns. It would show the correct data even if he had received no accessions for many intervening years.

Where a taxpayer was an accessioneer in a given year, he would have to disclose on the accessions schedule the name, etc. of the transferor of the accession, its amount and that of any annual exclusion(s) and any credit for the accessions tax against the federal income tax liability of the accessioneer (assuming that the credit is to be handled that way). The accessions schedule would be set up to assist the accessioneer in his cumulative computation of the accessions tax due, taking into consideration any flat tax paid by a trustee for which the accessioneer was claiming a credit, with the name of the trustee and date of payment, etc. The bottom line would show the accessions tax liability for that year,

the cumulative accessions tax paid, the cumulative accessions (net of annual exclusions) and any credits to be carried forward by the accessioneer.

Trustees would be required to file accessions tax information returns in the year of a distribution of income or corpus from the trust to an accessioneer. If there is a tax on direct skips, then donors would also have to report outright transfers to an accessioneer.

If a supplemental flat tax is imposed, trust income tax returns would have to ask whether, as a result of the death of someone in an older generation and the elapse of 50 years from the date of creation of the trust, a flat tax was due. If so, a flat tax schedule could be attached to the fiduciary return. Information about any flat tax paid by a trustee would be included on the accessions tax information return furnished an accessioneer at the time of any subsequent distribution to him which was subject to accessions tax. Thus, he would have all necessary information to compute his tax and any credits accompanying that particular accession.

11. In brief

While both of the other two alternatives have existed for a longer time and received far more study, attention and refinements, we nevertheless believe that the concept of the wraparound accessions tax (after necessary revisions) could turn out to be simpler to administer, and more equitable than the existing tax or the better known alternatives.

E. Comments on the proposals in appendicies 2 (from The Wall Street Journal) and 3 (Tax Notes)

1. The Lassila proposal for an accessions tax supplement to the estate and gift taxes and an accessions tax substitute for the generation skipping tax

Professor Dennis R. Lassila of Texas A & M University, in an editorial page article published in the August 31, 1984, Wall Street Journal, reproduced in Appendix 2, advocates repeal of the present Generation Skipping Transfer Tax and the substitution of a better system.

He criticizes the size of the \$1 million exemption in the Treasury proposal and the exemption of most people from the tax in the ALI proposal. He considers the latter to be nearly as complex as current law. His proposed accessions tax supplement to the existing estate and gift tax laws imposes an accessions tax not only on generation skipping transfers, but also on outright gifts and inheritances received by people only one generation below the donor, although he would only partially subject these transfers to an accessions tax (perhaps through the granting of a 50% deduction).

He would impose a flat 15% or 20% accessions tax on gifts and inheritances that do not skip a generation, in addition to federal gift or estate tax. Thus, these would be subject to such taxes twice; first at the time of the original transfer and then again at the death or subsequent transfer of the property by an accessioneer one generation below the transferor. Despite a \$10,000 annual exclusion and a \$200,000 lifetime exclusion for each accessioneer, this would add a new tax where the existing gift and estate taxes appear to be performing their proper role. It would further complicate the

administration of estates and the handling of intrafamily transfers for a majority of people.

A tax on generation skipping transfers (whether in the form of the existing one, the two major proposals before this Committee or the accessions tax proposed above by the Connecticut Bar Association), does not affect the vast majority of people or of events in the wealth transmission process. On the other hand, by imposing a supplemental accessions tax on transfers to the next generation, as Professor Lassila advocates, a whole new tax burden is placed upon everyone.

Professor Lassila would exempt gifts and inheritances received by charity and by persons in the same generation or in generations above the transferor, while taxing generation skipping transfers and transfers to the next generation at half the rates of generation skipping transfers. He would not impose the accessions tax on generation skipping transfers from generation skipping trusts to people in a generation below that of the transferor at the time of their creation. The accessions tax he proposes (like that of the Connecticut Bar Association) would apply only when the generation skipping transfer vests in the recipient (the accessioneer).

The Lassila accessions tax on generation skipping transfers is substantially what the Connecticut Bar Association proposes. However, the Connecticut Bar Association opposes taxation of outright transfers to the first generation below the transferor (albeit even partially) in addition to the estate and gift taxes on these transfers.

and has grave doubts as to the wisdom of taxing direct generation skipping transfers (as set forth in more detail in Part D above).

Professor Lassila's observation that an accessions tax applicable to all generation skipping transfers (direct and indirect) and apparently on direct (outright) transfers to the next generation, by capturing both direct and indirect transfers, would bring in more revenue than the current generation skipping tax is probably correct. But this is largely because he proposes an accessions tax on direct transfers to people one generation below the transferor.

2. The Bravenec-Lassila proposal for an accessions emphasis

The Special Report, "An Accessions Emphasis for Federal Estate and Gift Taxes," in the September 10, 1984, issue of Tax Notes, by Professors Lorence L. Bravenec and Dennis R. Lassila of the graduate tax faculty of Texas A & M University, reproduced as Appendix 3, is really not an accessions tax at all. No tax is imposed on an accessioneer. While the authors advocate repeal of the Generation Skipping Transfer Tax, they would replace it with revision of the estate and gift tax system in a way that would give the latter more of the qualities of an inheritance tax than of either an estate or an accessions tax. Their proposals would necessarily complicate the operation of the estate and gift taxes.

The Connecticut Bar Association's proposal for a wraparound accessions tax and the similar portion of the earlier Lassila proposal (without Professor Lassila's proposed

additional estate tax on transfers one generation below the transferor) should not directly affect the estate and gift taxes themselves, but only replace the Generation Skipping Transfer Tax with a simpler system. The Bravenec-Lassila proposal, by calling for a restructuring of the estate and gift taxes so that there are three classes of taxable transfers, appears to be far more complex.

The authors state (in their conclusion) that one of the advantages of their proposal is that it works within the present established estate and gift tax system and eliminates the need for a separate tax system for generation skipping transfers. On the face of it, this would appear to have been a good argument for enactment of their proposal as part of the major restructuring of the estate and gift tax laws that occurred in 1976, at the time that the Generation Skipping Transfer Tax was first enacted.

However, now that there have been two major restructurings of the estate and gift tax laws in the last eight years (1976 and 1981), together with a number of "minor" changes affecting various types of transfers of property and valuation issues in 1978, 1982 and 1984 (not to mention the enactment in 1976 of carryover basis and its repeal in 1980), it would appear more appropriate merely to replace the Generation Skipping Transfer Tax with as little disturbance as possible to the estate and gift tax structure.

The Treasury, ALI and Connecticut Bar Association proposals deal solely with the Generation Skipping Transfer Tax, as does the second portion of the earlier Lassila

proposal. But the Bravenec-Lassila proposals would build on the present estate and gift tax structure. In replacing the Generation Skipping Transfer Tax they would revise the entire transfer tax system. We do not support revision of this system, which has been refined over so many years, although we agree with the suggestion for a separate accessions tax.

The objectives all of us are trying to attain include simplification of this system, particularly as applied to all but the largest estates. The changes advocated by Professors Bravenec and Lassila would affect most estates and require much replanning, as did the major changes in 1976 and 1981, to take advantage of their new inheritance tax type of structure. But all that is really needed is to deal with the Generation Skipping Transfer Tax, without involving the estate and gift taxes.

Professors Bravenec and Lassila, by using the 100% and 50% deduction approach to different classes of transfers and transferees concede (or advocate) that estate and gift tax rates would be raised and/or the unified credit lowered, to make up for any lost revenue. Thus, their system is even more of a hybrid estate and inheritance tax than exists at present. (The present marital deduction is an inheritance tax feature.)

Their expansion of the no-tax group from surviving spouses and charities to people in generations above the transferor would not be of particular benefit to many people, since most transfers are not made to ancestors, uncles or aunts. The possible further expansion of the no-tax group to persons in the same generation, such as siblings and cousins and the

creation of a preferred tax group to include children and others one generation below the transferor and people who are more than one generation below, when there is no living person in an intervening generation), would further increase tax pressures to distort estate plans, as well as complicate matters.

Tax planning and calculations for those estates subject to the federal estate tax (as well as donors subject to the federal gift tax), but who are not now subject to the Generation Skipping Transfer Tax (except under unusual circumstances) would be complicated. A large group of people would be affected, unlike the number affected by proposals that deal only with the Generation Skipping Transfer Tax.

The concern the professors express over the risk that transfers in trust could indefinitely postpone the accessions tax by making no distributions is somewhat unrealistic. Such trusts would no doubt be rare. Ultimately, the accessions tax base would be increased by the accumulations. In any case, if necessary a supplemental flat tax could be adopted to allay this concern.

The necessity of aggregating all trusts created by the same transferor continues the information gathering problem of the current generation skipping tax. A progressive accessions tax would more effectively solve the problem of multiple trusts.

The lack of an exemption or exclusion is another weakness. Its absence overlooks the existence of non-tax reasons for many generation skipping trusts. Furthermore,

transferors should not be subjected to a new tax until their assets reach a very substantial figure.

IV. Conclusion

It may be that at a future date the Congress could re-examine the entire transfer tax system, with a view to replacing it with something else, such as a pure accessions tax or the hybrid Bravenec-Lassila tax. However, at this time, there appears to be a consensus in the Government and among the professional groups that the Generation Skipping Transfer Tax, as it presently exists, must be repealed and a more workable system to deal with generation skipping transfers put in its place. To go beyond this and re-examine the entire structure now is premature.

Additional studies need to be made by professional groups of alternatives to the estate and gift tax laws. Until these are published and critically examined by people other than those making the studies, the Congress should merely replace the existing generation skipping transfer tax system and not modify the estate and gift taxes again.

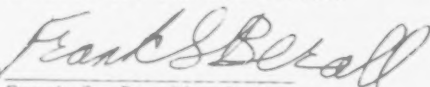
The Connecticut Bar Association does not believe that the present Generation Skipping Transfer Tax nor any of the substitutes for it are intended to be revenue producers. The policy of these taxes (including that of the wraparound accessions tax proposed by us), is to supplement the estate and gift taxes without necessarily insuring that wealth is taxed at least once every generation.

While insufficient information is available to us to be

able to comment on the revenue aspects of our proposed wraparound accessions tax, as compared with the other proposals being considered, we believe that it would do away with the concept of a deemed transferor and, especially if the flat tax is considered unnecessary, greatly simplify taxation of generation skipping transfers.

Respectfully submitted,

CONNECTICUT BAR ASSOCIATION

By, 

Frank S. Berall, Chairman,
Estates and Probate Section
and former Chairman of the
Tax Section of the Connecticut
Bar Association

Besides Attorney Berall, the other draftsmen of this testimony were Professor Mary Moers Wenig of Bridgeport, Attorney Clark M. Whittemore, Jr. of Greenwich and Attorneys Suzanne S. Bocchini, Charles R. Moore, Jr., John W. Hincks and Norman E. Armour, all of Hartford.

We are also grateful for the comments of Attorney Frederic P. Werner of Hartford and for suggestions about the wraparound accessions tax from Attorney L. Henry Gissel of Houston, Texas.

APPENDIX 1AUTHORITY AND IDENTITY OF THE ABOVE NAMED AUTHORS OF THESE
COMMENTS

The basic policy positions taken in the comments urging retroactive repeal of the present Generation Skipping Transfer Tax and finding a more acceptable alternative were authorized by the Connecticut Bar Association, based on the recommendation of its duly constituted Estates and Probate Section.

The Executive Committee of that Section is appointed from its members by the President of the Connecticut Bar Association, in consultation with the President Elect and the incumbent and immediate Past Chairmen of the Section. At the time this testimony was authorized, the Executive Committee consisted of the following lawyers:

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APPENDIX 2

How to Tax Grandpa's Generosity

By DENNIS R. LASSILA

The frequent use of generation-skipping transfers of wealth is allowing taxpayers to legally circumvent one of the most fundamental tenets of our estate- and gift-tax law: that taxes on the transfer of wealth from one person to another should be paid at least once by each generation within a family. Congressional concern over loopholes in the law could lead to a complete overhaul of some of the methods by which wealth is passed through generations.

Next month the House Ways and Means Committee will hold hearings on this subject. It will address serious problems created by a 1976 law, enacted to plug loopholes in the tax law. Such loopholes allowed people to avoid paying wealth-transfer taxes at each family generational level. For example, a grandfather making a direct transfer of stock as either a gift or inheritance for his grandchildren could avoid such taxes—in effect, "skipping" one generation. Taxpayers have used such devices to substantially diminish the effectiveness of the tax. Furthermore, the legal profession increasingly believes the law's complexity makes it unworkable.

In broad terms, a generation-skipping transfer passes along wealth either by inheritance at the death of the grantor or through gifts by the grantor to grandchildren or other persons more than one generation removed from him. An example: Assume a grandfather were to create a trust containing IBM stock and that the trust would pay his son the dividends as long as the son was alive. Upon the son's death the stock would be transferred to his children. Prior to the 1976 law, no wealth-transfer tax would have been paid by the son because he would have had the right to receive only income from the trust and would not have received the stock outright as his children had.

The 1976 generation-skipping transfer tax proved to be extremely complex—its provisions are some of the worst in what is an incredibly complex tax code. For example, in order to determine the generation-skipping tax on property received by a grandchild from a trust created by his grandfather's will, it is necessary to treat this transaction as if the property had been received directly from the grandchild's father, living or deceased. The father is termed the "deemed transferor" of the property. The generation-skipping tax is then computed using the father's marginal estate- or gift-tax rate. The current generation-skipping tax rate may be difficult, at

best, to determine—particularly if the father has been dead for many years.

Considering the tangled problems of the current system, the generation-skipping transfer tax should be repealed and a better system substituted.

The House hearings will largely consider separate proposals by the Treasury Department and the tax advisory group of the American Law Institute to change the method of taxing generation-skipping transfers. But very few would be taxed under the Treasury proposal because the first \$1 million of transfers made in a lifetime by each person would be exempt from the tax. The ALI proposal would also exempt most Americans from the tax and, in some ways, is nearly as complex as the current law. I believe a broader proposal should be considered that places the burden where it properly belongs—on the recipients of gifts and inheritances, unlike the above proposals under which the burden generally falls on the grantor or the trust involved.

We should replace the present tax with an accessions tax that would supplement existing estate- and gift-tax laws. It would tax grandchildren and other people more than one generation removed from the grantor at, say, a flat 30% or 40% rate on gifts and inheritances received in the form of a "full ownership interest" in property or its money equivalent. Outright gifts and inheritances of property received by the first generation removed from the giver (such as sons, daughters, nephews and nieces) would be only partially subject to such a tax (perhaps through the granting of a 50% deduction).

Gifts and inheritances received by charity and by persons in the same generation as, or in generations above, that of the giver would be totally exempt from the accessions tax. To minimize administrative problems, I would suggest that the first \$10,000 of gifts and inheritances received each year by each recipient be exempt from the accessions tax. In addition, each recipient should be permitted a lifetime maximum exclusion of \$200,000.

Transfers of less than a full ownership interest in property (such as in the creation of a generation-skipping trust) would not be subject to an accessions tax when the trust is created. However, the trust's creation would be subject to estate or gift taxes in accordance with current law. An accessions tax would be payable when grandchildren or others more than one generation removed from the trust grantor (such as great-nephews and great-nieces)

receive distributions from it. No such tax would be imposed on trust payments received by children of the grantor and other recipients only one generation removed from him. This is because when a grandchild is the recipient it is clearly a generation-skipping transfer that should be fully taxed.

The accessions tax would be applicable to all generation-skipping transfers and would be simple to calculate because a flat rate of tax would be imposed on the recipient of the transfers. Since such a tax would capture both direct and indirect transfers it would, in all likelihood, bring in more revenue than current laws. In light of this, federal estate- and gift-tax rates could be lowered somewhat, even below the reduced rates enacted by Congress in 1981.

Mr. Lassila is a professor of tax policy at Texas A&M University. 8-31-84

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APPENDIX 3

AN ACCESSIONS EMPHASIS
FOR FEDERAL ESTATE
AND GIFT TAXES

By Laurence L. Bravenec
and Dennis R. Lassila

Professor Laurence L. Bravenec and Professor Dennis R. Lassila are members of the Graduate Tax Faculty, Texas A&M University, College Station, Texas.

In this article, the authors propose an accession tax emphasis in the present estate and gift tax system to deal with the problem of generation-skipping transfers. Under their proposal, the present generation-skipping transfer tax system would be repealed and the present estate and gift tax system modified. Deductions of up to 100 percent would be granted for qualified transfers to certain persons while transfers in trust would not qualify for any deduction unless the transfer is considered the equivalent of full ownership.

The article also compares the accessions emphasis proposal to the present generation-skipping transfer tax system, the Treasury Department's generation-skipping tax proposal and the ALI Discussion Draft proposal.

I. INTRODUCTION

The problem of generation-skipping transfers is well recognized and has received wide attention in recent years.¹ In 1976 Congress enacted a comprehensive set of rules to govern the taxation of generation-skipping transfers. Unfortunately, the present generation-skipping transfer (GST) tax system is generally regarded to be complex and sometimes acts as a trap for the unwary. As noted in a recent article by Consuelo Kertz,² the many statutory definitions of the GST system put a premium on careful planning, and the absence of final regulations and decided case law add to the uncertainty of the practitioner and the IRS alike. While the well-advised taxpayer can generally avoid the GST tax by techniques such as "layering" his estate and making direct transfers to younger generation beneficiaries, the ill-advised taxpayer may inadvertently be faced with the GST tax because a beneficiary has a contingent interest or because a related

trustee has overly broad administrative powers. Consequently, there have been many calls for reform or outright repeal of the present GST tax system.

The Senate version of the Tax Reform Act of 1984 (TRA) contained a provision sponsored by Senator Steven Symms, R-Idaho, which would have retroactively repealed the GST tax.³ However, the House version of the TRA contained no GST tax provision.⁴ Apparently feeling that it would be inappropriate to eliminate the GST tax provisions without adopting an alternative system, the Conference Report on the TRA did not include the Senate provision.⁵ Thus, the present GST tax system continues to be the law. However, these actions should not be interpreted as a signal that the law will not be changed or eliminated in the near future. On October 2, 1984, the House Ways and Means Committee will hold hearings on proposals to simplify and/or eliminate the GST tax. Among the proposals that will be evaluated is a proposal advanced by the Treasury Department that will change, rather than reform, the GST tax system.⁶ The Ways and Means Committee will also review the recent American Law Institute (ALI) Discussion Draft proposal to change the taxation of GST.⁷

We believe that none of the above alternatives represent a satisfactory way to handle the problem of generation-skipping transfers. Instead, we feel that an accession

¹Senate Report No. 98-169, 98th Cong., 2d Sess., 716 (1984).

²44 R. Report No. 98-432, 98th Cong., 2d Sess. (1984).

³44 R. Report No. 98-861, 98th Cong., 2d Sess., 1237 (1984).

⁴Letter from John E. Chapoton, Assistant Secretary for Tax Policy, to Sen. Steven D. Symms (R-Idaho), Chairman, Senate Finance Subcommittee on Estate and Gift Taxation, with Proposal on Generation-Skipping Transfer Tax, issued April 29, 1983. The proposal has subsequently been presented in draft bill form.

⁵American Law Institute, "Federal Estate and Gift Tax Project: Study on Generation-Skipping Transfers under the Federal Estate Tax, Discussion Draft No. 1" (March 28, 1984).

¹See for example, American Law Institute, *Federal Estate and Gift Taxes 1985* and the Joint Committee Report on the Tax Reform Act of 1976, H.R. 10812, 94th Cong., 2d Sess., 564 (1976).

²Kertz, Consuelo, "A Comparison of the Current Generation-Skipping Transfer Tax and the Recent Treasury Proposal," *Tax Notes*, October 31, 1983, p. 363.

An accessions tax is an excise tax on the transfer of money and property by gift or on death, but it is imposed on the recipient of the property....

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emphasis in the present estate and gift tax system would more fairly and equitably deal with the problem of generation-skipping transfer. What follows is a description of our proposal for an accessions emphasis to the present estate and gift taxes and a comparison of the proposal with the present GST tax system, the Treasury's GST tax proposal and the ALI Discussion Draft Proposal. (It should be noted that in place of the suggested accessions emphasis approach for the present estate and gift taxes, there could be a separate accessions tax or flat rate surcharge based on principles discussed herein.)

II. THE ACCESSIONS EMPHASIS PROPOSAL

An accessions tax is an excise tax on the transfer of money and property by gift or on death, but it is imposed on the recipient of the property or property interest rather than on the donor or the decedent's estate.⁶ In this sense, the accessions tax is similar to state inheritance taxes which are imposed on the recipients of inheritances while transfer taxes such as the present federal estate and gift taxes are imposed on the transferor of inheritances and gifts and have a base measured by the total amount of gratuitous transfers made by the donor-decedent.

One of the arguments supporting an accessions tax system is that the tax is imposed on the persons who benefit the most from receiving property gratuitously, the transferees.

An accessions tax system was first proposed by Professor Harry Rudick in 1945 as a complete substitute for the then existing federal estate and gift tax system.⁷ Subsequently, Professor William Andrews proposed an accessions tax system as a "Reporter's Study" as part of American Law Institute's 1968 publication on federal estate and gift taxation.⁸ Andrews also proposed the accessions tax as a replacement for the federal estate and gift tax system. One of the arguments supporting an accessions tax system is that the tax is imposed on the persons who benefit the most from receiving property gratuitously, the transferees. The transferees also ultimately bear the burden of a transfer tax anyway.⁹ On the other hand, a significant problem under Andrew's accessions tax proposal is the handling of transfers in trust. If estate and gift taxes were eliminated, no tax would be imposed until distributions were made from the trust. Thus, tax under an accessions system could be postponed for years by not making any distributions from the trust.¹⁰

⁶Andrews, William D., "Reporter's Study of the Accessions Tax Proposal," in American Law Institute, *Federal Estate and Gift Taxes*, 1968, p. 446.

⁷Rudick, Harry, "A Proposal for an Accessions Tax," *Tax Law Review*, Vol. 1 (1945), p. 25.

⁸See Note 3.

⁹See Andrews, Note 8.

¹⁰To deal with this problem, Andrews proposed a special estate tax to apply to transfers made in trust of \$500,000 or more.

We propose an accessions emphasis to the present federal transfer tax system, with the following changes:

1. The present GST system would be repealed, but the present estate and gift tax system would be modified.

2. Deductions, generally 100 percent and 50 percent, would be granted in the case of qualified transfers to certain persons, and the estate and gift tax rates would be raised and/or the unified credit lowered to make up for any lost revenue.¹¹

3. Transfers in trust (and other transfers of less than full ownership) would not qualify for any deduction unless considered to be the equivalent of a transfer of full ownership.

The deduction (No. 2) will give the estate and gift taxes an accessions tax emphasis, in that qualified transfers giving rise to a 100 percent deduction would be subjected to no tax and those giving rise to a partial deduction would be subjected to preferred treatment. However, this approach does not substitute a pure accessions tax, as the amount of tax is still based on the decedent-donor's total transfers (after deductions) to all transferees.

Further, the treatment of trusts (No. 3) will be the replacement for the present GST system. Also, the new system will build on the present estate and gift tax system, thus making use of the widespread knowledge of this system.

Determining the Deduction on Transfers of Full Ownership or Its Equivalent

In determining the amount of deduction permitted for certain transfers under the modified estate and gift tax system, it is necessary to distinguish between the following groups of persons when there is a transfer from the donor-decedent of full ownership or its equivalent (the concept of full ownership equivalent is covered later).

Group I: The No Tax Group. Transfers to or for the benefit of persons in Group I would not be subject to a transfer tax if the transfer is of full ownership or its equivalent. This group would be identified largely in relation to the donor-decedent. Under the present estate and gift tax system, only transfers to the spouse of the donor-decedent and charitable beneficiaries are exempt from tax. However, Group I could be expanded so that one or more additional classes of generations above that of the donor-decedent could be exempted from transfer taxes, such as ancestors, aunts, and uncles. Group I could also be expanded to include persons in the same generation as that of the donor-decedent, such as brothers, sisters, and cousins.

Group II: The Preferred Tax Group. Transfers to or for the benefit of persons in Group II would be only partially taxed if the transfer is of full ownership or its equivalent. This group would also be identified generally in relation to the donor-decedent. Group II would include children of the donor-decedent and other persons who are not more than one generation below that of the donor-decedent. It would cover grandchildren and descendants belonging to lower generations only in limited situations such as when intervening generations are deceased at the time of the transfer.

¹¹It would also be possible in place of a deductions approach to apply a flat rate accessions surtax on transfers which would not qualify for the deduction as described herein. See Note 14.

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Group III: The Full Tax Group. Transfers to a natural person within Group III of an ownership interest or its equivalent would be fully taxed. The full-tax group would include grandchildren and great-grandchildren of the donor-decedent and other persons who are more than one generation younger (as defined under the present GST tax provisions) than the donor-decedent.

As mentioned earlier, transfers to persons belonging to Group I would not result in an estate or gift tax if the transfer is of full ownership or its equivalent. A 100 percent deduction would be provided for such transfers, thereby exempting covered transferees from tax. Although an exclusion for such transfers would also exempt the transferees, the 100 percent deduction approach is best because it is currently used to shield transfers to the spouses of donor-decedents and to charitable organizations from transfer taxes.

Transfers to persons belonging to Group II would result in a partial tax. The preferable mechanism would be to grant a deduction of perhaps 50 percent on transfers to persons in Group II (with no deduction permitted on transfers to members of Group III).¹⁴ Further, Group II could be broken into subgroups and a different deduction percentage (e.g., 40 percent and 60 percent) applied to each, if it is desired, to distinguish among different degrees of kinship to the decedent.

Definition of Equivalent of Full Ownership Interest. Interests in trust or otherwise that are considered to be the equivalent of full ownership must be defined. In this connection, transfers giving rise to an automatic marital deduction (i.e., the estate trust and the life interest with general power of appointment trust) under the present estate and gift tax system could be used as two types of full ownership equivalents. For that matter, the mere possession of a general power of appointment should be considered a full ownership equivalent under the proposal (although this result is not indispensable), because the proposal seeks to build on the concepts and approaches of existing law. Further, certain interests could be considered the equivalent of full ownership at the election of the parties.¹⁵ For example, the concept of the

qualified terminable interest transfer could be borrowed from the present marital deduction.

The following examples illustrate the determination of transfer tax on transfers of full ownership or equivalent interests.

Example 1: In 1985, Blake, who is not married, makes a gift of some land to his father. The value of the land is \$1,800,000. The transfer will not be subject to any gift tax because a 100 percent deduction would be allowed in computing the amount of the gift subject to tax. Blake's father is a member of Group I: the No-Tax group.

Example 2: Assume the same facts as in example one except that the land is given to Blake's son and that Blake had not given any previous taxable gifts. Using rates currently in effect and applying current law, Blake would be liable for a gift tax of \$183,050, computed as follows:

Gross Gift	\$1,800,000
Minus Annual Exclusion	-10,000
Gift (Net of Annual Exclusion)	\$1,790,000
Minus 50 percent deduction	-895,000
Taxable Gift	\$ 895,000
Gift Tax	\$ 304,850
Minus Unified Credit	-121,800
Gift Tax Liability	\$ 183,050

Note that the 50 percent deduction is permitted because the son is a member of Group II: The Preferred Tax Group.

Example 3: Assume the same facts as in example two except that the land is given to Blake's grandson at a time when his parents are alive. Blake would be liable for a gift tax of \$564,500, computed as follows:

Gross Gift	\$1,800,000
Minus Annual Exclusion	-10,000
Taxable Gift	\$1,790,000
Gift Tax	\$ 686,300
Minus Unified Credit	-121,800
Gift Tax Payable	\$ 564,500

No deduction is permitted on the transfer to Blake's grandson because the grandson is a member of Group III: The Full Tax Group.

Example 4: Assume that instead of making an outright gift of the land, Blake transfers the land in trust for the benefit of his son, giving the son a general power of appointment over the land. The amount of gift tax payable would be the same as calculated in example two because the transfer is of a full-ownership equivalent and the son is a member of Group II: The Preferred Class. If the transfer had been made for the benefit of Blake's father, no gift tax would have been payable—see example one.

Example 5: Assume the same facts as in example four except that the transfer is made for the benefit of Blake's grandchild. Blake would have to pay a gift tax of \$564,500 (see calculations in example three) because no deduction is allowed on the transfer.

¹⁴An alternative approach, which recognizes the interdependence of treatment of Groups II and III, would be to tax transfers to members of each group at regular rates under the present estate and gift tax system and to impose a flat rate accessions surtax (e.g., at 40 percent) payable by the donor or the decedent's estate on transfers to persons in Group III in excess of an exemption amount (e.g., \$300,000). The use of a flat rate would preclude the need to calculate a tax based on cumulative taxable accessions but, because of the exemption, the scheduled average rates would still be somewhat progressive. However, the accessions surtax would probably be less acceptable politically than the deductions approach.

¹⁵The proposal is flexible enough so that the concept of a full ownership equivalent could be elected in many kinds of situations.

For example, a parent creates a trust for the benefit of child X during her life, followed by a life interest in another child Y during his life, followed by a life interest in a grandchild Z, and then followed by a remainder interest in Z's children. It could be possible to create an election by X to treat the property as being gifted outright to her, so that the initial transfer in trust is to a Group II member and so that on X's death a transfer is considered as made by X, at which time Y could be given a similar election.

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Determination of Tax on Transfer of Interests Which Are Not the Equivalent of Full Ownership

Transfers in generation-skipping trusts and other generation-skipping arrangements which are not considered to be the equivalent of full ownership will be subject to federal estate or gift taxes at the time of the transfer. The tax would be computed on the fair market value of the property transferred using applicable estate and gift tax rates. In effect, the trust or other arrangement would be treated as a person in Group III.⁸ (Hereinafter, these trusts and other arrangements will be known as "Group III trusts.")

Subsequent Transfer of Full Ownership Interest. When there is a subsequent transaction in which an individual receives full ownership or its equivalent over some portion of the Group III trust (as by a transfer from the trust), the trust's transfer tax liability (if any) would be determined as follows for the following groups of beneficiaries:⁹

Groups I and II. A transfer by the trust to an individual belonging to Group I or II would not be subject to any transfer tax on such a transaction; that is, there would be a 100 percent deduction. This approach is in recognition that full taxation (with no deduction) was imposed on the transfer to the trust, even though there was a potential Group I or II beneficiary.

Group III. A transfer to a member of Group III would be subject to a partial tax if it took place within 25 years of the date of the prior completed transfer by the donor-decedent; it would be subject to full tax if made after the expiration of that 25-year period.¹⁰ Alternatively, the transition from partial to full tax on transfers to members of Group III could be phased in gradually. For example, if a deduction of 50 percent were provided for partial taxation, the deduction could be decreased by two percentage points for each complete year following the prior completed transfer to the trust.

The following are examples of events which could be considered a transfer of full ownership interest by a Group III trust:

- a) The lapsing of a general power of appointment resulting in a beneficiary's having a full ownership equivalent.

⁸A similar approach was used in the American Law Institute's Federal Estate and Gift Tax Project Study on Generation-Skipping Transfers under the Federal Estate Tax. Discussion Draft No. 1 (March 28, 1984).

⁹For this purpose all Group III trusts created by the same grantor are to be treated as one trust. Thus, if a grantor created three Group III trusts, the transfer tax on a gratuitous transfer made to a natural person within Group III would be determined as follows:

- (i) Calculate the transfer tax on the sum of that taxable transfer plus all previous transfers made by all Group III trusts created by the same grantor; and

- (ii) Subtract the amount of transfer tax on all previous transfers by the Group III trusts to members of Group III.

Notice that the method of calculating such transfer tax is the same as that used to calculate gift taxes under current law (section 2502). No annual exclusions would be permitted, however.

¹⁰See note 17.

- b) The termination of a life estate when there are not intermediate estates; or
- c) The distribution of principal from a trust.¹¹

The imposition of only a partial tax on transfers to persons in Group III within 25 years after the prior completed transfer by the donor-decedent is in recognition of the fact that a full transfer tax was paid within the previous 25 years on the property. We feel that transfers within the first 25 years do not have the generation-skipping potential of transfers after 25 years.

The new system will build on the present estate and gift tax system, thus making use of the widespread knowledge of this system.

It will be necessary to aggregate all transfers by Group III trusts created by the same donor-decedent.¹² Otherwise, there would be an incentive to create multiple trusts in order to have the benefit of lower incremental rates and of the unified credit.

The following examples illustrate the application of the calculation of the transfer tax on transfers into and out of Group III trusts.

Example 1: Suppose that, in 1985, Anderson, a widower, creates two trusts. The first trust is to pay income to his son, Bill, for life with the remainder to Anderson's grandson, Mark. The second trust is to pay income to Anderson's son, Bob, for life with the remainder to Anderson's grandson, Ted. Blank Bank is the trustee for each trust, and as trustee it has the right to invade principal in each trust for the benefit of the life tenant and/or remainderman. Anderson transfers property worth \$1,000,000 into each trust. He has made no previous taxable gifts. Both trusts are not considered to be an equivalent of full ownership. Each trust is a Group III trust and Anderson will pay a transfer tax of \$650,000 on the transfer (after subtracting the \$121,800 unified credit on creation of the trusts).

Example 2: Continuing the facts of example one, suppose that after eight years, in 1993, the first trust distributes \$225,000 of corpus to the son, Bill. There will be no transfer tax on the transfer because, while the transfer is of full ownership equivalent, there is a 100 percent deduction permitted for such transfers out of a Group III trust to an individual belonging to Group I or Group II.

Example 3: Continuing the facts of example one, suppose that in 1997, the trustee pays \$700,000 out

¹¹The distribution of income from a Group III trust could also be considered a transfer of a full ownership interest by the trust. However, a deduction or tax credit for the amount of transfer taxes paid should be provided in determining the transferee's income tax on the distribution. This would partially or totally alleviate the problem of double taxation on income distributions from trusts which are subject to both transfer and income taxes.

¹²See note 17.

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of corpus to the grandson, Mark, from the first trust. The first trust would be liable for a transfer tax of zero, computed as follows:

Gross Amount of the Transfer	\$700,000
Minus 50 percent deduction applying to the transfer	-350,000
Taxable Transfer	\$350,000
Transfer Tax	\$104,800
Minus Unified Credit	-192,800
Transfer Tax Payable	\$ 0

The transfer tax is zero due to the fact that a 50 percent deduction was permitted in computing the taxable amount of the transfer. The 50 percent deduction was permitted because the transfer was made within 25 years of the date the trust was created.

Example 4: Continuing the facts of examples one through three, assume that in the year 2012 (27 years after creation of the trust), Anderson's son, Bob, dies. At that time, the assets of the second trust, worth \$3,000,000, pass to the remainderman, grandson Ted. Further assume that this is the first transfer to a grandson since the one described in example three, above. Assuming that present transfer tax rates will be applicable in the year 2012, the trust will pay a transfer tax of \$1,258,000 on the transfer, computed as follows:

Transfer tax on the three million dollar transfer plus the previous \$350,000 taxable transfer	\$1,450,800
Minus Transfer Tax on \$350,000 previous transfer	-104,800
Tax on \$3,000,000 transfer	\$1,346,000
Minus Unused Portion of Unified Credit (\$192,800 - \$104,800)	-88,000
Transfer Tax Payable	\$1,258,000

Note that since the transfer occurs more than 25 years after the creation of the trust it is fully taxable. Further, the transfer is aggregated with the previous taxable transfer made from trust one for purposes of calculating the tax.

III. SUMMARY OF THE ACCESSIONS EMPHASIS PROPOSAL

The following is a general summary of our accessions tax proposal:

1. The present estate and gift tax system would be retained, but modified.
2. The present GST tax system would be repealed.
3. Transfer tax for Transfers of Full Ownership and the Equivalent of Full Ownership
 - Group I—No tax
 - Group II—Partial tax
 - Group III—Full tax
4. Transfer tax for Transfers of Other Than Full Ownership and the Equivalent of Full Ownership
 - a) Into a trust or other arrangement—generally subject to full transfer taxes to decedent-donor computed under present estate and gift tax rules (as if made to a Group III beneficiary)
 - b) Out, that is a subsequent transfer of full ownership or its equivalent from the trust or other arrange-

ment—subject to full transfer taxes to the trust as follows:

Group I and II—No tax (i.e., a 100 percent deduction for a transfer to members of Group I and II)

Group III—partial tax (e.g., a 50 percent deduction for a transfer to members of Group III) if transfer is within 25 years of the prior completed transfer in trust.

Group III—full tax if transfer is 25 or more years after the prior completed transfer in trust.

IV. COMPARISON OF ALTERNATIVES

Consuelo Kertiz's article covered the main aspects of and differences between the present GST tax system and the Treasury proposal.¹¹ This part of the article compares some of the major distinctions between our accessions emphasis proposal and the present GST tax system, the Treasury proposal, and the ALI Discussion Draft Proposal.

Transfers in generation-skipping trusts and other generation-skipping arrangements which are not considered to be the equivalent of full ownership will be subject to federal estate or gift taxes at the time of transfer.

The Present GST Tax System and the Treasury Proposal

The accessions emphasis proposal differs from both the current GST tax system and the Treasury proposal in three fundamental ways. First, the accessions emphasis proposal gives explicit recognition to the desirability of the effective transfer tax rate having a relationship to the class of beneficiary, i.e., it has an accessions emphasis, while the current GST tax system and the Treasury proposal do not. Secondly, the accessions emphasis proposal also differs from the other two approaches in discouraging long-term trusts and other arrangements for Group III beneficiaries by reducing the amount of taxes paid on a distribution from a Group III trust or arrangement to a Group III beneficiary if the distribution occurs within 25 years of the prior completed transfer into the Group III trust or other arrangement. Neither the present GST system nor the Treasury proposal distinguish between the treatment of transfers based upon their timing. Thirdly, the accessions emphasis proposal differs from the present GST system and the Treasury proposal in that the accessions emphasis proposal is merely a proposed change in the way estate and gift taxes will be determined for particular gratuitous transfers. This eliminates the need for an additional set of rules to apply to GS transfers. As such, the accessions emphasis proposal would result in a much needed simplification of the transfer tax rules overall. In contrast, under the present GST system and the Treasury proposal, an additional set of rules is used to determine the tax consequences of GS transfers.

¹¹ See Kertiz, note 2.

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The Present GST System

The accessions emphasis proposal also differs from the present GST tax system in two additional ways.²² First, the accessions emphasis proposal would be applicable to both direct and indirect generation-skipping transfers whereas the present GST tax system applies only to transfers made through generation-skipping trusts or their equivalents (that is, indirect transfers). The proposal thus would affect "layering" and would eliminate one of the most serious shortcomings of the present GST tax system—the failure to deal with direct GS transfers

Under the present . . . tax system, it is difficult to ascertain the tax rate(s) that will apply to the transfer.

Another difference is that the accessions emphasis proposal would not be based on the transfer tax position of some deemed transferor, having no necessary relationship to the taxed transfer, as under the GST tax system. Under the present GST tax system, it is difficult to ascertain the tax rate(s) that will apply to the transfer. In the case of the accessions proposal, gratuitous transfers of full ownership or their equivalent are taxed to the transferor at a rate based on the class of beneficiary involved. The transferor is also subject to taxation on the gratuitous transfer of interests of less than full ownership in trust or similar arrangements (Group III trusts or arrangements). Finally, Group III trusts or arrangements pay a transfer tax on transfers of full ownership or their equivalent to beneficiaries belonging to Group III, but not to beneficiaries belonging to Group I or Group II.

The Treasury Proposal

The main additional difference between the Treasury's GST tax proposal and the accessions proposal is that under the Treasury proposal, each grantor is entitled to make up to \$1 million of cumulative lifetime and testamentary generation-skipping transfers without incurring a GST tax. Thus, under the Treasury proposal all but quite wealthy grantors will escape coverage. Under the accessions emphasis proposal, there is no comparable exemption or exclusion.

The ALI Discussion Draft Proposal

The ALI Discussion Draft Proposal for taxing GS transfers is much more like the accessions emphasis proposal than the present GST tax system or the Treasury proposal.²³ For example, the ALI proposal is primarily based

on a distinction between the treatment of "owned" trusts and "non-owned" trusts. The definition of an "owned" trust under the ALI proposal is very similar to the definition of a trust which is the equivalent of a transfer of full ownership under the accessions emphasis proposal. Likewise, "non-owned" trusts for ALI proposal purposes are similar in definition to trusts which are not the equivalent of full ownership (the Group III trust or arrangement) under the accessions emphasis proposal. Further, this second kind of trust is treated as a separate transfer tax taxpayer under both proposals. The ALI proposal and the accessions emphasis proposal are also alike in providing for taxation of outright GS transfers.

However, there are some significant differences between the ALI and accessions emphasis proposals. The following are the major differences between the two.

1. The ALI proposal would repeal the provisions of sections 2041 and 2514 covering the transfer tax treatment of general powers of appointment. The accessions emphasis proposal, in contrast, builds on the present estate and gift tax system and thus would treat general powers of appointment as equivalent to full ownership unless there were some compelling reason for repealing or modifying present law.

2. The proposals treat outright GS transfers differently. Under the ALI proposal, an outright GS transfer is one which is made by an individual or an owned trust to grandchildren or more remote descendants, to nonrelated individuals more than 35 years younger than the grantor, or to an owned trust for the benefit of such persons, but does not involve a transfer to a "non-owned" trust. The ALI proposal would impose a special surtax on outright GS transfers, a proposal which is both complex and politically weak. In contrast, the accessions emphasis proposal treats outright GS transfers as Group III transfers in subjecting them to a full tax and in not granting them preferential treatment. This latter proposal is simpler and more politically acceptable than the surtax. Moreover, it has the significant advantage of building on existing law.

The ALI proposal would impose a special surtax on outright generation-skipping transfers, a proposal which is both complex and politically weak.

3. The two proposals also differ in their treatment of distributions by "non-owned" (Group III) trusts. Gratuitous transfers by "non-owned" trusts (Group III trusts) to grandchildren and other persons more than one generation below that of the grantor are subject to transfer taxes under both proposals. Under the ALI proposal, such transfers are taxed to the trust at the maximum marginal transfer tax rate in effect at the time of the transfer, and a special GS transfer tax credit of up to \$417,000 (based on transfer tax rates expected to be applicable in 1988) per grantor is available to offset such tax. Further, a transfer tax at the highest marginal rate is applied to the fair market value of the trust corpus upon a "taxable termination" of the trust, similar to the current law's definition of taxable terminations under section 2613.

²²Another difference is that the present GST Tax System gives a \$250,000 exclusion per deemed transferor for GS transfers to grandchildren of the grantor. Under the accessions emphasis proposal, no exemption or exclusion would be permitted for gratuitous transfers to grandchildren of the grantor. However, this difference is not significant, because the \$250,000 exclusion could easily be taken out of the present GST system or added to the accessions emphasis proposal.

²³American Law Institute, *Federal Estate and Gift Tax Project Study on Generation-Skipping Transfers under the Federal Estate Tax Discussion Draft No. 1* (March 28, 1984).

Under the accessions emphasis proposal, on the other hand, transfers by a Group III trust of full ownership equivalent to a grandchild or other beneficiary more than one generation below the grantor subjects the trust to the regular transfer tax at the time of the transfer, and the unified credit is allowed. No special generation-skipping credit is created. Further, there is no taxable termination provision under the accessions emphasis proposal. Instead, GS transfers made by the trust within 25 years after the creation of the trust are only partially taxed, while GS transfers made after 25 years are fully taxed.

It seems unduly harsh to fully tax transfers to non-owned trusts as if the trust were a separate transfer tax taxpayer and then to impose another full tax upon a subsequent distribution by the trust to a grandchild of the grantor. . . .

It seems unduly harsh to fully tax transfers to "non-owned" trusts as if the trust were a separate transfer tax taxpayer and then to impose another full tax upon a subsequent distribution by the trust to a grandchild of the

grantor, regardless of the time interval between the creation of the trust and the distribution. The accessions emphasis proposal recognizes the relevance of this time interval by imposing only a partial tax if there is a distribution to a Group C beneficiary within 25 years of the creation of the trust.

The ALI proposal is also unduly complicated by its deemed distribution rules, which could be triggered by the death of all members of an intervening generation. It is politically weak because Congress should realize that such an event could escape notice and could create taxpayer resentment at the time the tax is imposed. The accessions emphasis proposal, on the other hand, focuses on distributions, events which are less likely to escape notice or to create taxpayer resentment. At the same time, the accessions tax proposal encourages early distributions by making the amount of tax dependent on the length of time between the creation of the trust and the distribution.

V. CONCLUSION

The accessions tax proposal would deal effectively with generation-skipping transfers, would greatly simplify the determination of tax on GS transfers, and would be imposed differentially depending upon the status of the beneficiary relative to the donor-decedent. This proposal has the added advantage of working within the present established estate and gift tax system, and eliminates the need for a separate tax system for GS transfers.

Mr. JACOBS [presiding]. Ms. Springs, is your objection to the generation-skipping tax on current income from established trusts based entirely on the difficulty of administration, or does it rest on an objection to the very theory of taxing the current income from trusts?

Ms. SPRINGS. Primarily on the issue of administrative ease.

Mr. JACOBS. Is there a certain theory, a range of logic to the theory of the taxation of the current income from an established trust? Somehow, that seems like the other side of the coin of your answer.

Ms. SPRINGS. I am having difficulty hearing you, sir. I am sorry.

Mr. JACOBS. All I can tell you is, welcome to the club. This is probably the worst room in the Capitol to try to communicate. I don't even think the great communicator would do well in here.

Is there a range of logic to the taxation of current income from a settled trust?

Ms. SPRINGS. Yes, I think there is a range of logic.

Mr. JACOBS. Fine.

I thank the panel on behalf of the committee. You have made a useful contribution to the committee's deliberations.

The next panel is the Honorable Wilbur D. Mills, former chairman of this committee; and Vester T. Hughes, Jr.

STATEMENT OF WILBUR D. MILLS, SHEA & GOULD, WASHINGTON, DC, ACCOMPANIED BY STUART A. SMITH, SHEA & GOULD, NEW YORK, NY

Mr. MILLS. Mr. Chairman and members of the committee, I am pleased to appear today to discuss the very important issues presented by the generation-skipping transfer tax.

It is good to be back occasionally.

The committee has before it two separate bills which purport to simplify the generation-skipping tax. Distinguished representatives of the Treasury and the American Law Institute have respectfully spoken in support of these measures, and the committee will doubtless hear further testimony focusing on the details of these two bills.

I would like to invite the committee to take this opportunity to engage in a broader searching examination of the generation-skipping tax, and to identify the fundamental problem with respect to which the tax purposes to offer a solution.

Although technical tax questions rarely produce unanimity of views, I think it is fair to say that no one—practitioner, government official, or academician—believes the current version of the statute to be fair or workable.

The law raises almost insuperable problems of administration and compliance from the viewpoint of both taxpayer and the Internal Revenue Service.

The generation-skipping tax has been in effect for almost 8 years.

Nevertheless, apart from certain effective-date provisions, no final Treasury regulations have ever been promulgated. Moreover, it took more than 6 years for the Treasury to publish necessary tax return forms.

It is therefore an understatement to assert that the present statutory system is entirely unsatisfactory. The law is complex, and practitioners find it so unworkable that they are unable to meet the minimal reporting requirements.

Whatever goals the tax sought to achieve, it is plain that the costs of compliance, both public and private, far outweigh the \$280 million annual revenue it is estimated to raise in future years.

In these circumstances, it is incumbent upon the Congress to reconsider whether the public interest is served by a tax law of minor fiscal significance that few people can understand and obey.

In my view, the consequent disregard for the present law necessarily undermines our system of voluntary self-assessment.

Our present unified estate and gift tax is a transfer tax that is based upon the theory that transfer of property—both during lifetime and at death—should be subject to a graduated rate. That system has been in place since 1916.

It is intended to diminish concentration of inherited wealth. The statute is replete with provisions designed to sweep back into a person's gross estate property transferred to succeeding generations when the transferor maintains control of enjoyment of the property.

However, if property is transferred during lifetime with no strings attached, a gift tax is imposed upon the transferor but the property is no longer included in the estate of the transferor for estate tax purposes.

In 1976, Congress departed from this basic structure with the enactment of the generation-skipping transfer tax. The basic transaction at which the tax took aim was the transfer in trust—where a person transfers property to a trust, the income from which is payable to his child for the life of the child, and the remainder interest is paid over to a grandchild upon the death of his parent.

Under the law as it existed prior to 1976, the termination of the interest of the life estate was not a taxable event unless the beneficiary had a general power of appointment with respect to the trust property.

The nonimposition of the estate tax upon the death of the intervening life beneficiary was seen as an abuse that was permitted by the trust technique.

Hence, the generation-skipping tax was designed to reconstruct the result that would have occurred had the property in question actually been transferred outright from generation to generation.

As a mechanical matter, the tax treats the life beneficiary as a "deemed transferor" and the tax is computed by reference to the transfer tax bracket of the deemed transferor.

The fundamental rationale of such a tax is not the long-standing transfer theory upon which the unified estate and gift tax is based. Rather, the generation-skipping levy is based upon the separate and distinct notion that capital or wealth should be periodically taxed at every generation.

In the example of the trust, the intervening life beneficiary has not transferred anything to the succeeding generation in any volitional sense of the word.

But under the generation-skipping tax, his death, nevertheless, serves as the occasion for the imposition of a tax on the family fortune, despite his lack of control over its disposition.

We may indeed question the propriety of such a periodic tax which taxes wealth for wealth's sake and thereby discourages the formation of capital and savings.

Moreover, the present bills before the committee demonstrate that the periodic tax on wealth rationale has now become the dominant consideration of those that favor the continuation of the generation-skipping tax.

While the creation of the generation-skipping trusts was alleged in 1976 to be an abuse of the estate tax, both the Treasury and the American Law Institute now propose that the tax be extended to cover outright transfers that skip an intervening generation.

Hence, an outright transfer from grandfather to grandson would be subject to the generation-skipping tax, as well as the gift tax.

This extension is sought in the name of "tax neutrality." It is argued that outright skips should not enjoy any more favorable treatment than skipped transfers in trust.

Furthermore, both the Treasury and the American Law Institute contend that not to tax outright skips would favor the "super rich" who can more easily afford making outright generation-skipping gifts than the mere wealthy who must confine their generation-skipping transfers to trusts.

To begin with, I question the premise upon which the proposal is based. If outright skips are taxed at the time they are made, estate planners may well opt for the creation of trusts since the tax will not be paid until the death of all first-generation beneficiaries.

More importantly, the extension of the tax to outright skips strays far afield from the original intent of the 1976 law which focused on trusts. In the case of a trust, the intervening life tenant at least has the benefit of enjoyment of the property even though he does not own the property outright.

I do not agree that the termination of a life estate is a proper occasion for a transfer tax. Nevertheless, it can hardly be denied that such a case is far removed from an outright gift to a grandchild where the intervening generation has had no enjoyment of the property.

I think to defend that kind of extension, you have to subscribe to the notion that the estate and gift taxes must be imposed once a generation, however the property is actually owned or enjoyed.

But this notion is simply a periodic wealth tax under the guise of estate tax reform. If Congress seeks to enact such a tax, it should do it directly and call it by its proper name.

It is, nevertheless, argued that the addition of a \$1 million generation-skipping transfer tax exemption will exclude the vast majority of persons from the imposition of the generation-skipping tax. That may well be the case.

But those of us who have long been involved in the enactment of tax legislation are fully aware of the fact that a \$1 million exemption proposed by one of the tax-writing committees can quickly become a \$100,000 exemption before the statute is finally enacted.

Indeed, the present \$250,000 grandchild exclusion in the law started out as a \$1 million proposal. If the fundamental theory

upon which the generation-skipping transfer tax is defective, it should not be cured by enacting an exemption that seeks to insulate the measure from broad political criticism.

Accordingly, the estate and gift taxes are not and should not be stalking horses for a periodic tax on capital, a wealth tax.

Nor should the integrity of the present transfer tax system be compromised by introducing notions that are better attributable to an accessions tax.

Finally, the effectiveness of the present system should not be judged by measuring it against a hypothetical periodic tax on wealth.

Since the primary rationale of the present system is to diminish concentrations of inherited wealth, we surely accomplish this object when a person passes part of his property to more distant relatives such as grandchildren.

To enact a tax that discourages such transfers seems contrary to the goals of the unified estate and gift tax system.

In sum, the present bills of both the Treasury and the American Law Institute demonstrate that the generation-skipping tax is an ever-expanding solution in search of an elusive problem.

Given the relatively small revenues produced by this measure, I think the committee should do well to consider enacting a moratorium of the tax, pending an intensive study of the entire area.

In making this recommendation, I am well aware that a similar moratorium proposal was not enacted in 1982. But the proposed extension of the tax to outright skips lends new urgency to the need for considered judgment in this area.

As Justice Frankfurter once observed, "if wisdom comes, we should not reject it simply because it comes late."

[An attachment to the statement follows:]

ADDENDUM TO THE STATEMENT OF WILBUR D. MILLS

In order to consider the propriety of the generation-skipping transfer tax, Congress must address three questions. Does the tax raise significant revenues? Can the tax be administered effectively, in terms of both cost and compliance? Finally, does the tax serve the purposes intended for it by the Congress?

The revenue impact of the generation-skipping transfer tax seems to be minimal. In 1976, the staff of the Joint Committee on Internal Revenue Taxation prepared a study that indicated that the short-range estimate of generation-skipping tax revenues was practically zero and that the long-range estimate was approximately 280 million dollars per year. At the time these projections were made, they assumed a unified credit of \$47,000. Now, the amount of that credit has dramatically increased so that for taxable years beginning in 1987, the allowable unified credit will be \$192,800. It therefore seems clear that the long-range revenue estimates would be reduced significantly below the 280 million dollar figure proposed in 1976.

Moreover, the generation-skipping transfer tax is insignificant within the context of the Unified Federal Estate and Gift Tax. During 1981, all federal transfer taxes in the aggregate were estimated to produce 7.5 billion dollars. Thus, had the 280 million dollars of estimated long-range generation-skipping tax revenue been available in 1981 instead of 15 years later, it would have represented only 3.8% of aggregate 1981 Federal Transfer Tax Revenues. In light of these figures, it is hard to defend the generation-skipping transfer tax on the grounds of revenues exigencies.

Furthermore, the generation-skipping tax cannot be effectively administered. Putting aside the very substantial costs upon the private sector, the tax puts the Internal Revenue Service to the almost impossible task of keeping records with respect to all trust beneficiaries and all trustees under the hundreds of thousands of generation-skipping trusts that are in existence. In order to administer the tax correctly, the Internal Revenue Service will have to maintain information as to when each interest or power under each such trust terminates and when each trustee dies or

leaves office. It will have to maintain information as to when and how much property is added to all pre-June 12, 1976 irrevocable trusts in order to determine the extent to which such trusts have been subject to the tax. It will also have to know when and in what fashion powers of appointment are exercised under generation-skipping trusts, and when interests or powers under such trusts are disclaimed or assigned.

Moreover, the government will have to stockpile similar information with respect to the multitude of "trust equivalent" arrangements subject to the tax. Surely enforcement and collection of the tax would require an enormous amount of staffing. Given the complexity of the statute, it is not at all likely that there will be taxpayer self-assessment with respect to the generation-skipping transfer tax. In these circumstances, it is clear that the generation-skipping transfer tax will foster disrespect for our voluntary self-assessment tax system.

Finally, it is long overdue for Congress to ask whether the generation-skipping tax serves the purposes intended for it. At the time of its enactment in 1976, Congress believed that the generation-skipping transfer tax would cure the "abuse" caused by the establishment of inter vivos trusts. At that time, the Senate Committee Report observed that Congress was not attempting to punish users of trusts but rather it was striving to make "the tax laws * * * neutral" in the context of trusts. S. Rep. 94th Cong., Second Sess. 20 (1976). But at hearings held by the subcommittee on estate and gift taxation of the Senate Finance Committee in 1981, there was ample testimony that in practice the generation-skipping transfer tax has been anything but "neutral" in its impact upon trusts. A variety of witnesses stated that the generation-skipping transfer tax has added a significant cost to the preparation and administration of trusts. Moreover, the tax has caused taxpayers to change their natural dispositive preference in favor of the recommendations of estate planners. Most people do not intend their trusts to run for generations, but rather resort to trusts as protectors of property until children reach an age when they may be relied upon to use such property prudently. Indeed, even as to multi-generational trusts, property paid out to beneficiaries is, without the generation-skipping transfer tax, subject to the Federal Estate and Gift Tax systems.

In sum, the generation-skipping transfer tax reaches far beyond the sort of behavior it should be designed to correct, and, by doing so, intrudes in an inappropriate manner into the estate planning process. Although so-called "tax avoidance arrangements" were alleged to be the primary target of the tax, the tax reaches a vast number of trust and non-trust arrangements (1) that are not motivated by a desire to avoid Federal Transfer Taxes, (2) that have a finite duration far shorter than the maximum period permitted by the rule against perpetuities, and (3) that involve interests that are not tantamount to outright ownership but that are very limited in terms both of duration and economic significance.

The tax has a dramatic overreach. It covers situations where tax avoidance is the furthest thing from the transferor's mind. For example, the tax applies to many common estate plans involving outright distribution to children on their attaining a stipulated age. If these children die prior to reaching that age, the property to which they otherwise would be entitled passes over to their children. When the gift over to the second generation occurs, the tax applies even though it arguably should not be given the lack of transfer tax avoidance. Moreover, the tax broadly applies to any present interest, no matter what its duration or its value in economic terms. Whenever such an interest exists, the entire trust property of which that interest is a part is subject to tax. Consider the example where a father creates a trust for the benefit of his son, his grandson and his great grandson, instructing the trustee to pay such amounts of trust income to any one or more of these descendants at such time or times and in such equal or unequal proportions among them as the trustee deems advisable for these descendants' respective maintenance and medical care. Under the statute, this trust is a "generation-skipping trust". Suppose the trustee never pays any money to the son because, in the trustee's judgment, it is never appropriate to distribute income for the son's maintenance or medical care. In this circumstance, the son's death will be a taxable termination and a generation-skipping tax will be assessed against the entire trust property (less any grandchild exclusion) just as a Federal Estate Tax would have been assessed had the son owned the property outright.

But the son's interest is certainly not "tantamount to outright ownership". The son never received a cent from the trust. He never had a right to demand any money from the trust and had no expectancy whatsoever with respect to the trust corpus. His connection with the trust was so far short of outright ownership that one may legitimately question whether it is fair to subject the entire trust property to tax as if he were the owner.

The Committee now has before it two different proposals to "simplify" the generation-skipping transfer tax. Some aspects of those proposals are indeed quite commendable. For example, the Treasury proposal to impose a flat tax equal to 80% of the maximum transfer tax bracket eliminates the need for determining the identity of the "deemed transferor". In addition, the Treasury properly proposes a credit for any generation-skipping transfer tax imposed by a state.

But despite the existence of salutary amendments in the Treasury bill, it is distressing that the Treasury, as well as the American Law Institute, has proposed an extension of the tax to cover direct generation-skipping transfers. However, a careful examination of the history of Federal Transfer taxation will show that Congress has consistently rejected the basis upon which the Treasury proposal rests.

The first Federal Transfer Tax was an estate tax, a tax imposed on the privilege of transmitting property at death. The Federal Estate Tax was first enacted in 1916. Two years later, Congress enacted the Revenue Act of 1918 to "bring out more clearly the intention which Congress desired to prevail at the time of the original imposition of an estate tax". At that time, Congress extended the tax to apply to the exercise of a general power of appointment. The reason for this extension was that if a person has a general power of appointment, he is in a position not unlike that of the owner of the property because he has full authority to dispose of the property at his death. In these circumstances, Congress saw no reason why the privilege which he exercised should not be taxed in the same degree as other property over which he exercised the same authority.

Over the years, additional Federal legislation was enacted by the Congress to close perceived "gaps" in the system. Thus, a gift tax was imposed upon the privilege of transferring property by gift. In 1942, Congress extended the estate tax to apply to the mere possession of a general power of appointment. Thus, the system, consisting of an estate tax and a gift tax, taxed all transfers, intragenerational as well as inter-generational. The adoption of the generation-skipping transfer tax does not depart from these historical precedents but it extends the imposition of tax to far lesser economic powers and benefits than the estate tax and the gift tax.

It is important to recognize that all of the current taxes—gift, estate and generation-skipping—impose tax on the basis of benefits conferred or powers granted. The current proposal calls for the extension of the generation-skipping transfer tax to outright skipping transfers. But this would be the first time in our history that the Federal Government would impose a tax with total disregard of any economic benefit to or power of the individual to whom the tax in effect would apply. It is a concept that has been rejected by Congress on the several earlier occasions when it was proposed.

This extension of the tax is sought in the name of "tax neutrality" that presumably requires that property should be taxed "at least once every generation." But the tax on transmission of property has always been based on the privilege of transmitting property or property rights rather than on the receipt of property or property rights. If the outright skipping-transfer proposal is adopted, it will shift the basis of our transfer tax system to an inheritance or accessions tax. There is, however, no logical basis for such a drastic shift. Indeed, Congress consistently refused to adopt such proposals in the past and rejected a Treasury proposal to do so as part of the 1976 legislation.

There is, moreover, no "logical consistency" in taxing wealth once in each generation. Under our present system, property may be taxed more than once within a generation when a transfer is made from brother to brother followed by a transfer by the donee brother to his own children. If "neutrality" is sought, one would conclude that the tax application to the gift from brother to brother should be eliminated. In short, there is nothing more "neutral" about a tax once in every generation than there is in continuing to permit a skip in generation without tax where the skipped generation has absolutely no interest in or power over the properties transferred. The Treasury proposal to extend the tax to outright generation-skipping transfers is not new. A tax on such outright skips was proposed by the Treasury in 1969, yet it never received legislative approval. There has never been Congressional acceptance of the notion that wealth must be taxed once every generation. Indeed, there is no logical reason why wealth should be taxed once every generation any more than it should be taxed once every second or third generation. If the principle were fully accepted, Congress would be required to enact a capital levy to be imposed not less often than every 25 years. Surely such proposal would radically change the transfer tax system which has been in place for almost 70 years.

Finally, the proponents of the extension of the tax to direct skips argue that if the tax is so extended, tax considerations will become less important in estate planning. I submit that quite the opposite is the case. If the tax is so extended, practitioners

will revert once again to the use of traditional multi-generation-skipping transfer trusts. Upon the creation of such a trust, the generation-skipping transfer tax would not be payable until the death of the intervening generation. On the other hand, a trust to pay income to a second generation or outright gifts to a second generation would be subject to tax immediately. The proposal would thereby create new planning opportunities to defer payment of the tax. Instead of giving property to grandchildren, taxpayers would once again be advised to establish long-term generation-skipping trusts, giving present interests to as many first generation beneficiaries as possible in order to delay the tax as long as living first generation beneficiaries can be found. The target of the Treasury proposal is the so-called "layering" technique by which very wealthy people can give outright gifts to their grandchildren and generations beyond without having the need to create trusts. But if the proposal is adopted, it is expected that "unlayering" would be the order of the day. It is hard to imagine that such "unlayering" is more socially desirable than "layering". Indeed, under the present tax system, the wealthy are encouraged to reduce their concentrations of property by passing them on to grandchildren and generations beyond.

In sum, the estate tax has always been imposed upon the death of a person holding property or some form of ownership equivalent of property. Until 1976, a taxable ownership equivalent required more than an economic interest. Rather, some power over the transferred assets was also needed. The 1976 law sought to expand the concept of ownership equivalence. It has proved to be unworkable. Surely the solution is not to adopt a proposal which would expand the scope of this discredited tax when that proposal has been consistently rejected in the past. Let us instead take the proper time to identify the problems of our present system rather than expanding upon a defective and unworkable base.

Mr. PICKLE [presiding]. Thank you, very much.

Before we ask any questions, we will proceed with the next panelist, Mr. Vester Hughes, a very distinguished attorney from my home State, and a man recognized in the tax field as a very outstanding expert, so we are pleased to have you here, Mr. Hughes.

Please proceed.

**STATEMENT OF VESTER T. HUGHES, JR., HUGHES & HILL,
DALLAS, TX**

Mr. HUGHES. Thank you, Mr. Chairman, let me say at the outset that I echo the sentiments of Mr. Mills.

It seems to me that what is needed at this point in time is not an examination of generation skipping. Indeed what has been put forward by both the Treasury and the draft of the American Law Institute reporter is something other than a generation-skipping proposal.

It does address the generation-skipping problem, but it goes a good deal farther, because, encompassing direct transfers to grandchildren, we move into the area of something that is in the nature of an accessions tax.

Now, a country can decide to tax wealth in a number of ways.

In 1916, Congress approached this on the basis of an estate tax—that is, a tax on the transferor and based on what the transferor sent out from himself.

Another approach that has been followed by many States is, of course, the inheritance tax, which looks to the recipient.

A perhaps better tax that works like an inheritance tax is the accessions tax, which asks how much property did the recipient accede to from whatever source?

Finally, of course, there could be a periodic wealth tax. This might take a constitutional amendment, but a wealth tax could be imposed every certain number of years.

The problem with both the Treasury proposal and the draft of the American Law Institute is that neither represents a coherent choice among the fundamentally different approaches to wealth taxation.

Let me say at this point I would reiterate what Mr. Gutman so properly stated—the draft of the ALI reporters has not gone through the procedural steps for it to become a recommendation of the American Law Institute. It is merely a draft of the reporters. It would have to go before the Council of the American Law Institute and before the body of the American Law Institute.

I doubt seriously that anything that eventually would emerge from that kind of careful consideration would encompass a tax on direct skips. It would be like treating a Treasury proposal as a congressional enactment to give more status to the current draft than what I have just stated.

In any event, it seems to me that we are at the appropriate time to consider wealth taxation in this country, to reconsider whether what was done in 1916, the determination to treat ownership—that is, the enjoyment of the property—as the basis of taxation, was the best choice.

Now, indeed in 1976 we said that this had gone too far, and Congress enacted provisions that sought to tax further transfers that placed enjoyment in an intervening generation. This may or may not have been a good idea. Whatever its merits or lack of same, the 1976 law is unworkable, as many speakers have said today.

The first order of business should be the repeal of that law, and the enactment of another law should await Congress' determination of what the policy should be. In this regard, it seems to me that we should think in terms of the type of study Mr. Mills has suggested. Section 1081 of the current tax reform bill that was just enacted calls for a restudy of the income tax and alternative systems.

Why not restudy the estate tax at the same time? If a flat income tax were to be enacted, perhaps with certain exemptions the gift tax and estate tax could be repealed and wealth taxation could become a part of the income tax; that is to say, with certain exemptions, wealth transfers would be treated as income. It would greatly simplify reporting. It would greatly simplify administration.

In the 1890's the estate and gift tax laws were integrated with the income tax. Perhaps the progressivity of the gift tax portion of the income tax might be a little less steep than the income tax itself. But certainly these are the types of suggestions which, in a time of reform, should be studied further.

Again, I would like to associate myself with Mr. Mills' suggestion, but with the broader scope that now may be the time to put the income, estate, and gift taxes all under one roof, all administered by the same part of the Internal Revenue Service, and all with common definitions and a common approach to examination and reporting.

Thank you for this opportunity to appear before the committee.
[The prepared statement follows:]

STATEMENT OF VESTER T. HUGHES, JR., HUGHES & HILL, DALLAS, TX

I. BACKGROUND OF THE "GENERATION-SKIPPING PROBLEM"

A government that has decided to tax aggregations of wealth can choose among a wide range of alternatives. These alternatives can be grouped into taxes of three basic types: estate tax, inheritance or accessions tax, and periodic wealth tax. Beginning in 1916, the federal government selected the estate tax model. An estate tax taxes a transferor on transfers of ownership. Ownership is generally taken to mean the enjoyment of property coupled with the power to control the disposition of the property.

Although a fixture at the federal level, the estate tax approach has not vanquished the alternative possibilities. A number of states (and the federal government at the turn of the century) have imposed inheritance or accessions taxes. An accessions tax taxes the recipient on accessions to wealth, both gifts and inheritances, received from all sources. The progressive rate schedule is tied to the amounts received by a particular transferee, rather than to the aggregate transfers made by the transferor. The principal attraction of an accessions tax is that, unlike an estate tax, it applies directly to the aggregation and concentration of wealth. The tax is also tied more directly to the ability to pay of the living persons who must eventually bear the burden of any death tax.

A third system also exists. Aggregations of wealth may be taxed directly through the imposition of a periodic wealth tax. This would require that at certain intervals (e.g., once per year or once per decade) taxpayers declare and pay tax on their net worth. The states have long employed periodic wealth taxes in one form or another; local real property taxes are a prime example.

In a nutshell, the three types of wealth taxes may be summarized as follows: an estate tax levied on the transferor of assets, an accessions tax levied on the recipient, or a periodic wealth tax levied on the owner.

In light of these fundamental principles, what is the so-called "generation-skipping problem"? Prior to the latest proposals, the generation-skipping problem had been viewed as a definitional problem in the estate tax. In order to function, an estate tax must be able to identify its taxable event: transfers of ownership. Historically, however, certain arrangements have allowed a person to enjoy substantial benefits from property during life, and also to exercise substantial control over the disposition of that property, without the imposition of any tax when those benefits pass on death. Thus, generation-skipping has traditionally been viewed as a problem inherent in the nature of trusts. Trusts provide a socially desirable vehicle to permit adjustments in ownership interests in property without cumbersome transfers of title or other formalities. This power to unbundle and divide the elements of ownership and to readjust those divisions in subtle ways, makes it very difficult to determine when a transfer of ownership has occurred to trigger the imposition of an estate tax. The "generation-skipping problem" is the failure of the estate tax to identify transfers of ownership of assets in trusts.

II. PREVIOUS ATTEMPTS AT SOLUTION

The generation-skipping problem discussed above is far from new. The flexibility of executory interests and uses, the elements of modern trusts, threatened centuries ago to remove land from English commerce and to concentrate wealth in few hands. In response, English courts created the rule against perpetuities, which requires that ownership vest in persons within a specified period of time. This rule stood as the sole limit on generation-skipping for centuries. In 1942, Congress expanded the definition of ownership for estate tax purposes by narrowing the scope of powers of appointment which would be considered "special powers" rather than outright ownership. This experiment at dealing with skipping problems within the estate tax met with wide opposition and was repealed in 1949.

In 1976, Congress again tackled the generation-skipping transfer tax. Although set up as a separate tax, the 1976 generation skipping provisions are really a complex expansion of the preexisting estate and gift tax rules. The provisions were designed to include within the estate tax concept of transfer of ownership, certain shifts of beneficial interest in trust assets. There was nothing radical in this attempt to extend the estate tax system. Unfortunately, it is not easy to shift through the great variety of possible sifts in beneficial interest and to separate out the taxable transfers of ownership. The statutory language that attempts this feat is startling in its intricacy. Now, eight years later, even the Treasury Department admits that the existing generation-skipping tax is overly broad, impossibly complex, inadministerable,

avoidable, unfair, and logically inconsistent. Everyone agrees the 1976 generation-skipping tax must be repealed immediately and retroactively.

III. CURRENT PROPOSALS

The Treasury Department now trumpets a new "generation-skipping" proposal. This new proposal, however, despite its moniker, is not a new response to the problem that the 1976 proposal failed to solve. Instead, having failed to solve the original problem with the oppressive 1976 tax, the Treasury Department now seeks to change the problem. As explained above, the classical generation-skipping problem has been that the estate tax is triggered by transfers of ownership but substantial interests can be shifted and enjoyed in trusts without such transfers of ownership. Now, however, the Treasury Department is suggesting that the generation-skipping problem is, in fact, something completely different. The generation-skipping problem, we are told, is the failure of the estate tax to tax wealth once per generation.

This fundamental redefinition of the generation-skipping problem, which is the basis for the Treasury Department's new tax proposal, is truly remarkable. In enacting an estate and gift tax, Congress made a fundamental choice to tax transfers on transfers of ownership. Congress could have adopted an accessions or inheritance tax, basing the tax rate on the identity of the donee, but did not. Congress also could have adopted a periodic wealth tax, taxing net wealth every year, every decade or every generation, but chose not to do that either. Basically, the Treasury Department now asserts that the problem with the estate tax is that it is an estate tax.

The Treasury would like to portray its new proposal as an attempt to plug a "loophole" in the estate tax. But, the fact that property given directly to one's grandchildren is not included in the taxable estates of one's children can hardly be characterized as a loophole. Certainly, Congress has always known that people might make gifts or bequests to grandchildren. Implicitly (in choosing an estate tax system) and explicitly (in considering the 1976 generation-skipping tax) Congress has decided that gifts to grandchildren do not represent an abuse requiring a double tax. For example, the Senate report on the 1976 generation-skipping tax notes that "the tax would not be imposed in the case of an outright transfer from a parent to a grandchild (because the intervening generation receives no direct benefit from such a transfer)." Similarly, after a lengthy study in the 1960's, the American Law Institute concluded that "an additional tax should be imposed on an outright transfer, or its equivalent." In light of this history, it is completely disingenuous for the Treasury Department to suggest that the estate tax was intended to tax wealth once per generation. (In fact, of course, the Treasury Department does not now, nor has it ever, suggested a once-per-generation tax; for example, Treasury has never proposed an exclusion for transfers to siblings, nor has it suggested a credit for transfers to parents.)

The new Treasury Department proposal is not an attempt to plug some "generation-skipping loophole." Rather, the proposal reflects Treasury's dissatisfaction with the estate tax as a means of wealth taxation.

Treasury's basic argument, that a wealth tax needs to be imposed once per generation, would lead one to expect a proposal for a periodic wealth tax. That, however, would be too simple. Instead, Treasury seeks to approximate the effect of a periodic wealth tax by combining the present estate and gift taxes with a new tax that is akin to an accessions or inheritance tax. In short, a double tax. Inevitably, the result is a mess. First off, the new proposal is extremely complex—probably as complex as the unworkable 1976 law. With each session comes a new improved revised version of the proposal. There is no reason to think the need for revisions will stop if the legislation is enacted. Furthermore, in its zeal to maintain the purity of a fundamentally impure approach, Treasury has taken extreme positions. For example, the proposal would levy a double tax on a gift or bequest to a grandchild, even if the intervening child were deceased. Presumably, Treasury believes that such transfers are a loophole in the estate tax system. That is ludicrous. Treasury might as well say that the longevity of taxpayers who live years beyond the usual life expectancy is another loophole that needs to be plugged. The estate tax system was never designed to impose a periodic tax, so the failure to tax some wealth each generation cannot be considered a loophole.

The Treasury Department does not even pretend to deny that its new proposal is incredibly complex. Nor does Treasury attempt to justify this complexity by logically demonstrating that it is a necessary part of any effective estate tax. Instead, Treasury provides one answer that is supposed to silence all criticism. That answer is the \$1 million exemption. The Treasury Department may believe that response is

good politics, but no one can honestly contend that it is good policy. A complex and unjustifiable tax is not made simple or justifiable by excluding most constituents from its operation. Progressive taxation is properly achieved by enacting a sound tax system and graduating the rates as desired. To subject a minority of the population to a completely different taxing system which is otherwise unpalatable is not progressive taxation. It is unequal application of the law. If nothing else, the \$1 million exemption is tantamount to an admission on the part of the Treasury Department that most practitioners would never be able to apply the new proposed tax. In light of this admission, does anyone really believe that the judges and revenue officers, who cannot be selectively exempted out, will ever be able to administer this new tax fairly? This exemption is snake oil, not a cure-all.

The other new statutory proposal, based on the American Law Institute's incomplete generation-skipping project, differs from the Treasury proposal in certain respects. Most of these differences, however, are just mechanical. Like the Treasury proposal, the ALI proposal is extraordinarily complex. It also attempts to approximate the result of a periodic wealth tax by adding an accessions-type tax to the existing estate tax. The Institute does honestly admit, however, that the complexity of the tax cannot be realistically offset by providing an artificially large exemption. Instead, the ALI proposes a substantial credit and freely admits that this complex new tax will need to be considered in all trust planning.

IV. FUNDAMENTAL PROBLEM: FUNDAMENTAL REFORM

The first step toward a solution is to identify the real problem. The "generation-skipping problem" is not that the estate tax fails to levy a tax per generation. The enactment of an estate tax represents a fundamental decision to tax transfers of ownership rather than to tax ownership periodically. As has been suggested above, the real generation-skipping problem is the ability, through the use of trust arrangements, to enjoy property and pass on that enjoyment without the transfer of ownership required to trigger the estate tax. In fact, the generation-skipping problem is really just the most obvious part of a general "skipping" problem. Anyone, not just a member of the succeeding generation, who is able to enjoy property during life and pass on that enjoyment without a transfer of ownership has "skipped" an estate tax. Furthermore, the problems in wealth taxation may even transcend this expanded notion of skipping. The current flurry of activity in the generation-skipping area may be symptomatic of a pervasive dissatisfaction with the entire estate and gift tax system.

The existence of general dissatisfaction with the estate tax should not come as any surprise. As the American Law Institute noted in the 1960's and as Professor Shoup noted even earlier, the fundamental purposes of the estate tax have never been clear. The reasons that led the 1916 Congress to choose an estate tax, rather than an accessions tax or a periodic wealth tax, have never really been explored. Thus, it is not surprising that the Treasury Department's latest generation-skipping proposal betrays dissatisfaction with that choice. Generally, it would seem prudent to reconsider, in this time of tax reform, the relative merits of the different wealth taxation systems. Certainly, such a complete review is imperative before adopting a proposal which amounts to the addition of an accessions tax to the estate tax in an attempt to approximate a periodic wealth tax.

The goal is clear. All Americans would benefit from an equitable system of wealth taxation with clear purposes and policies. Whatever system is chosen should be coordinated with overall federal tax policy, and particularly with the individual income tax system.

The solution is not clear. Perhaps the estate tax should be preserved. Perhaps the events characterized as transfers of ownership need to be expanded, particularly in the area of powers of appointment. Perhaps an accessions tax would be preferable to an estate tax. These are issues which must be addressed now.

First step: the 1976 generation-skipping tax, which is in full force and effect right now and is causing havoc throughout the estate planning community, must be repealed immediately and retroactively. Everyone agrees this needs to be done. There is no excuse for not doing it now.

The next step is more difficult. There is dissatisfaction with the present system, but there is no consensus on how to properly tax wealth in America. This situation in the wealth taxation area is remarkably similar to the existing problems in the individual income tax area. In fact, this resemblance suggests the next step. In Section 1081 of the Tax Reform Act of 1984, Congress ordered a complete study of alternative income tax systems. A parallel comprehensive study should be undertaken in the area of alternative wealth tax systems. Such a study could include an examina-

tion of the wealth taxation experience of states and foreign countries. Problems created by trusts and powers of appointment could be reexamined in a fresh light. Most importantly, there is a tremendous opportunity to coordinate, and maybe even unify, the income tax and wealth tax systems.

Congress now has a unique opportunity to generate a coordinated study of federal income and wealth taxation. This study could lead to remarkable simplifications and improvements. For example, if Section 102 of the Internal Revenue Code, which excludes gifts and bequests from gross income, were simply repealed, the income tax would also be an accessions tax. The current income tax rates, however, are probably too steeply progressive to apply to estates. This objection might disappear, however, if gifts and bequests were included in the kind of broad based income tax with significantly lower rates proposed in the various "flat tax" plans. (In fact, the 1894 federal income tax was such a unified tax.) The 1977 Treasury Department book, "Blueprints For Basic Tax Reform," discusses methods of coordinating a consumption tax with a wealth transfer tax. These are ideas that deserve study. The opportunity to unify the two branches of individual taxation, which have grown up independently, should not be missed.

The 1976 generation-skipping tax will be repealed, and should be repealed now. Fundamental wealth taxation reform, however, should not sink in the mire of the new generation-skipping proposals suggested by the Treasury Department and the American Law Institute. Congress has recently expressed a willingness to move decisively to reform the income tax area; the estate tax is no less deserving of fundamental reform. Like the individual income tax, the estate tax has been allowed to accrete haphazardly over the better part of this century. Like the income tax, the estate tax deserves a new fresh look, not another layer of sediment. It would be a shame if Congress simply rubber-stamped the double tax that Treasury now proposes. It would be an opportunity forsaken. America deserves better. This should be the era of tax reform.

Mr. PICKLE. Thank you, Mr. Hughes.

Both of you gentlemen oppose taxing direct skips?

Mr. HUGHES. Right.

Mr. PICKLE. I can be sympathetic to that general view, as a grandfather.

Now, we do allow the \$10,000 per donee annual exclusion. That allows an individual to give some transfer of funds to grandchildren. Treasury's proposal allows a \$1 million per transferor exemption.

What level are you trying to exempt? Do you have a sum in mind that would be more appropriate than the \$1 million that the Treasury would give?

Mr. HUGHES. Well, not at all, Mr. Chairman. Let's assume that we are into 1987 and the top estate and gift tax rate is at 50 percent, as it will be. Let's assume that the transferor in a post-1987 transaction has already reached the top bracket. Now, at that point, assume he gives \$2 million to a grandchild. He will, in the first instance, pay \$1 million of gift tax.

What the Treasury proposal says is that that is not all of the tax. It says that 40 percent of the \$1 million that exceeds the \$1 million exemption should be taxed again. And so instead of \$1 million tax, we are talking about \$1,400,000 tax on the transfer of the \$2 million. This is true even though the son who was the father of the grandchild is deceased. So, what the bill would, in fact, do is to create a dual tax system.

The \$1 million exemption is not an exemption in the classical sense. This is not like the \$10,000 annual gift tax exclusion that is to take care of Christmas presents, as the original amounts were, or to take care of transfers over and above necessary expenses—trips to Europe, and what-not. It is not like the amount of nontaxable income that a person is allowed, before reaching the level of

income taxation, for minimum subsistence. This is imposing a second tier of taxation because of the recipient.

Now, it seems to me that Congress ought to look at the whole system—and this gets back to Mr. Mills' testimony. In 1916, Congress said, look at the transferor, look at the man who makes the transfer, the person who dies, the person who makes the gift.

What Treasury is seeking to impose here is a tax that looks at the transferee, who got it. I say, OK, maybe look at the transferee, but do it in the form of adopting an accessions tax, not an estate and gift tax. Maybe an accessions tax would be the better system.

I am convinced that the problem with drafting is a result of mixing inconsistent systems. If you look at the 1976 law, if you look at the current law and the proposals, they are very complicated—many sections, very difficult. In order to have the bridge from a tax on a transferor to a tax on a transferee concept you have to have a very, very difficult meshing of the two. It is that meshing that has also created the very difficult problems of administration.

Mr. PICKLE. Mr. Mills, do you agree with that?

Mr. MILLS. Yes.

Let me say this: I have always been leery of any suggestion, Mr. Chairman, that we amend the tax law and have an exemption from the effectiveness of it. Why exempt—if the suggestion is good tax policy, shouldn't everybody affected by it have to abide by it? I have always wondered why we would have an exemption for something if it was so good.

No; I don't have any amount of money in mind. I just think that we should confine transfer taxes to an actual transfer of ownership.

Mr. PICKLE. Both of you oppose the Treasury's approach then?

Mr. HUGHES. Yes, sir.

Mr. MILLS. Actually, Mr. Chairman, I am concerned, because the Congress in 1976—and I was still here then—enacted the Treasury proposal at the time, and the Treasury hasn't even been able to work out regulations on it yet. They don't even understand it.

Mr. PICKLE. Do you think, Mr. Chairman, that—

Mr. MILLS. I don't know but what maybe their present suggestion will be just as complicated as that.

Mr. PICKLE. If we were to pass either the Treasury approach or the ALI approach, do you think that Treasury would issue guidelines?

Mr. MILLS. Well, maybe in 8 or 10 years, yes.

Mr. PICKLE. Within how long?

Mr. MILLS. Eight or ten years. It has been 8 years, and they haven't done anything about the 1976 act yet, except in rare instances—dates and things of that sort.

Mr. PICKLE. Well, they have not put out any guidelines on the 1976 changes we made.

I am just wondering, will they delay again? I guess if we pass the law, you would have to assume they would have to issue guidelines as a followup to our legislation. But they have not done it for the present law. I think that is a problem. I recognize that.

Mr. Hughes, if I understand what you said, you say we ought not take this issue from a transfer perspective, but instead consider it as part of the income tax system. Is that the point?

Mr. HUGHES. Yes, Mr. Chairman. It seems to me that, given the new income tax law, integration may be possible. In 1987, the top estate and gift tax bracket is supposed to be 50 percent. The top income tax bracket is 50 percent. You have certain problems of how you handle tax basis and this sort of thing.

But if wealth taxation were to be combined into an income tax scheme that would mean that the estate and gift tax portion would really be an accessions tax. The idea of an accessions tax is that you look to the recipient, whether he got his property from his aunt, uncle, grandfather, great-grandfather, both sets of grandparents, and that would aim your tax at concentrations of wealth. Look at the recipient—not the person who transferred it, but the recipient. I think that it might well be melded into an income tax format, particularly if some of the new simplification proposals are adopted.

Mr. PICKLE. I don't know whether this approach has been recommended by anyone else who testified this morning.

Are you the only one that proposed this?

Mr. HUGHES. I believe this morning I am the only one that suggested it. But it came up in a discussion in the 1977 Treasury "Blueprints" proposal, and indeed it was a part of our system in the 1890's.

Mr. PICKLE. Mr. Mills, you closed out your very excellent testimony—Mr. Chairman, I waited 15 years to be able to hit the hammer on you.

Mr. MILLS. I used to do it to you, yes.

Mr. PICKLE. I am pleased to do it to get your attention.

Now you state in the conclusion of your testimony that this problem is an ever-expanding solution in search of an elusive problem. I think we all agree to that. Then you go further to say, that the committee should just enact a moratorium on the tax and have an extensive study.

Mr. Mills, do you think if we had a moratorium that we would come up with any kind of a solution from Treasury? They have already had a study, this has gone on for years, now they have made the recommendation. You don't like what they recommended. If we had a moratorium, I have a feeling this would be a moratorium ad infinitum, and we never would get anything done. I don't know if we will get it done now.

But if we put a stop to it, and not move ahead with any resolve, we surely will not accomplish it. Hughes said the ALI proposal it is not a recommendation but is just a general outline. They have not come forth with any solution.

So what good will a study do?

Mr. MILLS. Actually I have heard quite a number of discussions this morning that I think are better, really, than the Treasury or the American Law Institute proposals. They have been thrown out here.

I think they should be studied. Not everybody is in accord, of course, in the route to be taken, but just the mere moratorium would not do any good. But the study could develop a workable program for doing what needs to be done if there is something that needs to be done.

Mr. PICKLE. Yes.

Mr. HUGHES. One of the suggestions, Mr. Chairman, had been the approach that was taken in the installment sales area, also in the S Corp. area, where the whole matter of how should wealth transfers be taxed would be studied. Should it be an accessions tax which looks to the recipient; or should it be a transferor tax which was the 1916 solution and the one we have had since that time?

Or maybe we ought to have a constitutional amendment and, say every 20, 30, 40, 50 years, bing, you tax wealth periodically.

Any one of these is a doable thing, but, as Professor Shoup in 1957 and then the American Law Institute study that was completed in the 1960's and the current historical background all point out, not everybody is in agreement on what we are trying to accomplish with the estate tax.

There are various discussions about not too much concentration of wealth, not having a generation that doesn't work or what not, but if we knew where we were trying to go with it, I think we could come up with a better solution.

I, personally, prefer the accessions tax where you look to the person who gets it. It seems to me now we have the ideal time to put that on the income tax return. We have the time and we can look at it, and integrate the two tax systems and do away with some of the problems now.

We get rid of 68 years of history—but so be it.

Mr. PICKLE. Well, as just a typical Member of Congress, I have had a great deal of criticism from my tax attorneys and from accountants who deal with generation-skipping tax. They are all very unhappy with the present law because they don't know how to advise the client, they don't know what the guidelines of Treasury will be. Treasury has really fallen derelict in this respect.

My lawyers would like to do away with the generation-skipping tax and go back to the old system. I think that would suit both you gentlemen. But that doesn't really solve the question. I think we have to try to come up with some answers.

I can assure you that our professional staff, and the Treasury people will be working diligently here in this next session to see if we can come up with some answers. I think we need something. Otherwise there will be confusion or else noncompliance. I have a feeling a lot of people just don't pay attention to it now.

I don't know what will happen if the law ever catches them, but this is a problem for us. So I hope we can come up with some recommendations. I appreciate your testimony.

Mr. Hughes, I know you work in this field on an active basis. You are an outstanding authority in this field.

Mr. Mills is an authority on everything pertaining to the Tax Code because he wrote most of it.

So your testimony means a lot to us. We thank you.

Mr. MILLS. Thank you.

Mr. PICKLE. You honor us to come back and testify before our committee.

Mr. Duncan, do you have any questions?

Mr. DUNCAN. No; I have no questions, Mr. Chairman, but I would like to thank Mr. Hughes and our fine former chairman, Mr. Mills, for being here, and I apologize for not being here to hear you

at the beginning, but a prior commitment with constituents caused me to have to leave.

We always respect you gentlemen and the testimony that you provide.

Mr. MILLS. Mr. Chairman, let me say I have Stuart A. Smith who accompanied me here, and he is with the New York office of Shea & Gould.

Mr. PICKLE. We are glad to have you, Mr. Smith. Do any of you gentlemen wish to make an additional statement now?

Mr. HUGHES. I might say this, Mr. Chairman, that the perceived problem I don't believe exists. The repeal of the 1976 act would not truly damage either the revenues or the system. But that tax may be a very fine blessing in disguise in that it has triggered this investigation, because it may well be time, after 68 years now, to relook at, rethink, and reconsider what the tax system ought to be.

Again, I reassociate myself with Mr. Mills, that it is very desirable for the entire estate and gift tax area to be looked at and put in the perspective of true tax reform, which, of course, is what this committee in the Tax Reform Act said should be done to the income tax system. I think we are missing a golden opportunity if that is not done at the same time.

Mr. PICKLE. Thank you.

Mr. MILLS. I have just one further thought, if I can express it.

Mr. PICKLE. Yes, Mr. Mills.

Mr. MILLS. This idea of tax neutrality that comes into the discussion today, I don't understand if we have a problem in one area of the tax law why you seek to correct that problem and then under the guise of tax neutrality, you extend that rule across the board where perhaps there is no problem.

I am not convinced that there is a problem that exists today in the estate tax when a grandfather wants to give a part of his estate to a grandchild. I don't see anything wrong with that in the way of public policy. Why in the world it has to be assumed there are two transfers of that property, I can't see it.

But the idea comes under the expression of tax neutrality, because you found a problem here, you extend the solution of that across the board where there may not be a problem. This is a new thing to me.

Mr. PICKLE. Well, I think that the Treasury has recommended in years past this approach or some general approach like this for the purpose of raising revenues.

Mr. MILLS. If that is what they want, I can tell them where they can get revenue in a better way.

Mr. PICKLE. And it gets to be important, I remember a good friend of mine had a daughter who was going to get married, and she wasn't about 17 or 18, and she announced to her daddy that they were going to get married, and he didn't oppose it. He just said: "Well, you can do that, all right, but I want to ask you, what are you going to use to buy groceries with?"

Now, I make that observation to say that we have to raise revenues because we have to have revenue to run the Government, too. This may not be the biggest source, but it is a source. So we can't be unmindful of that fact.

Mr. HUGHES. I suggest that——

Mr. PICKLE. I would imagine you would agree with that in general?

Mr. HUGHES. Yes; but it is more than that. Certainly the Government has to have revenue, and certainly all sources should be looked to, but it seems to me that if the cost of administering this particular series of suggestions since 1976 and the cost of the consideration were weighed against the benefit, I think it is a very doubtful proposition as a revenue raiser.

The entire estate and gift tax is looked upon as insignificant in the total scheme of things. If that is true, this is among the more insignificant aspects of something that is already insignificant to begin with.

Mr. MILLS. Yes.

Mr. PICKLE. I recognize that you gentlemen are very, very sincere and are authorities in this field, so I know what you are saying is on the deep belief that we should not treat this matter as we are. Who knows what we will do, but we need to do something.

If there are no other comments or statements, the hearing on generation-skipping tax is adjourned.

[Whereupon, at 1:47 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

MICHAEL J. ANDERSON, INC.,
Sacramento, CA, July 25, 1984.

JOHN J. SALMON, Esq.,

Chief Counsel, Committee on Ways and Means; House of Representatives, Longworth House Building, Washington, DC.

DEAR MR. SALMON: I was surprised to see that Deficit Reduction Act of 1984 did not contain the repeal of the generation-skipping tax.

The provisions of the 1976 TRA dealing with the generation-skipping tax are in the opinion of all practitioners unworkable.

The Treasury in their April 19, 1983 generation skipping tax proposals for simplification are not the solution either. In particular the Treasury's reform proposals would propose a generation-skipping tax even if no beneficiary at the child level were entitled to benefits from the generation-skipping trust. Thus a direct transfer from a decedent to his grandchild would invoke not only a gift or estate tax but an immediate generation skipping tax.

I would only remind you that that was not the intent of the original generation-skipping tax proposals.

The intent of the act was to prevent property to be kept outside the transfer tax base for periods that could last as long as one hundred years while successive intervening generations could be given interests and powers which could come close to outright ownership of the property. For example, Dad leaves \$300,000 in trust for the benefit of S his son who is given all of the income, and has the power to invade corpus to the extent of \$5,000 or 5% whichever is greater and a limited power of appointment to appoint by will the trust property equally or unequally among his issue and finally is designated to act as trustee.

Upon S's death nothing will be included in his estate. The property if the limited power of appointment is not exercised would go to S's children. i.e. the grandchildren.

So therefore, please either conform the generation skipping statute to what the perceived problem is and make it workable or repeal it but do not accept the inconsistent proposals given to you by the Treasury.

Sincerely,

MICHAEL J. ANDERSON.

THOMPSON & MITCHELL,
St. Louis, MO, September 7, 1984.

Mr. JOHN J. SALMON,

Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Building, Washington, DC.

DEAR MR. SALMON: Enclosed herewith are six copies of a revised draft of the proposed Bill I mailed you on July 23, 1984, which attempts to simplify the present generation-skipping transfer tax system without undermining the essential fairness achieved under the 1976 Act. Also enclosed are six copies of an explanation of the Bill.

The revised draft incorporates the comments and suggestions of various members of the Bar who have reviewed the Bill. The time for paying the estate or gift tax attributable to the generation-skipping transfer under the revised draft will be postponed until the termination of the last interest in the property of an individual in the particular generation. In addition, payment of the tax attributable to the generation-skipping transfer will be the primary responsibility of the person receiving the property (rather than the executor or donor, who would then be forced to seek reimbursement from the person receiving the property).

Please substitute these materials for the materials I sent you in July and include them in the printed record of the October 2, 1984 hearing to consider simplification of the generation-skipping transfer tax. Again, although I presently do not intend to speak at the hearing, I nevertheless feel that the enclosed material merits careful consideration by the Committee as a possible alternative to the proposals of the Treasury Department and the American Law Institute. Copies of these materials have been sent to Representatives Dan Rostenkowski and Richard Gephardt, and to Senator Robert Dole.

If you should have any questions regarding the enclosed material, please feel free to contact me.

Respectfully submitted.

JAMES G. BLASE.

Enclosures.

SUMMARY AND EXPLANATION

This Bill would repeal chapter 13 of subtitle B of the Internal Revenue Code of 1954 ("Tax on Certain Generation-Skipping Transfers") and substitute in lieu thereof estate and gift tax provisions relating to certain generation-skipping transfers. The primary purpose of this Bill are threefold: (1) to simplify the present generation-skipping transfer tax scheme in a manner which will incorporate fully the policy reasons underlying the enactment of chapter 13 in 1976; (2) to impose an estate and gift tax on certain generation-skipping transfers in order to fit the tax on such transfers precisely within the present unified progressive rate transfer tax system; and (3) to create an acceptable compromise between the overly-complex and administratively impracticable provisions of present chapter 13 and the overly-simplistic and therefore inequitable provisions of the Treasury Department's proposal for a new generation-skipping transfer tax.

The basic policy underlying this Bill is substantially the same as that of the 1976 drafters of chapter 13. The primary differences are: (1) the tax under this Bill would be imposed in the form of an estate and gift tax; (2) the tax is not limited to transfers of property held in trusts or "trust equivalents", but rather covers any property in which persons in more than one generation have an interest; and (3) limited powers of appointment are not subject to the tax. Although the tax would be imposed in the form of an estate and gift tax, the tax itself would continue to come out of the trust (or other property), and imposition of the estate or gift tax attributable to the generation-skipping transfer will continue to be postponed until the last interest of a person in the particular generation is terminated. The "special rules" of present section 2614 will not be necessary under this proposal, nor will the burdensome administrative rules of present section 2621.

Under this Bill, the identification of a generation-skipping transfer should be fairly simple. When a person's present interest in property (other than income) terminates (whether by death or otherwise), including terminations caused by the distribution of such property (free of such present interest) to an individual assigned to a generation younger than that of such person, the trustee need then only identify the persons who have or had present or future interests in the property both before and after such termination or distribution, and then identify which generation those persons are in. The trustee will then insert the number of such persons into the fraction provided for in this Bill in order to determine the amount of the genera-

tion-skipping transfer. This amount will then be disclosed by the trustee as a separate line item on present Form K-1 for the trust (or other similar form, if desired) which is mailed to the beneficiary or to the executor of his estate. Since all records of any taxable transfers will be kept by the trustee, it should be relatively simple to identify any previous taxable transfers in order to determine the amount of any future taxable transfers.

Unlike the proposal of the Treasury Department, this Bill would not tax direct transfers to persons in generations below that of the initial transferor of the property. No direct transfer, in trust or otherwise, by the initial transferor of an interest in property to a person in a generation two or more levels below that of the initial transferor will be subject to this tax.

The formula for taxing generation-skipping transfers would only tax the person in a generation one level below that of the initial transferor to the extent of his proportional interest in such property. Once subjected to tax, this amount will not be subject to tax again in the same generation.

This Bill would do away with the departures and inconsistencies of the Treasury Department's proposal about which Malcolm Moore was concerned in his testimony before the Subcommittee on Estate and Gift Taxation on June 27, 1983. These concerns were: (1) taxation of direct transfers to younger generation beneficiaries; (2) application of the generation-skipping tax to distributions of trust income; (3) insufficient flexibility with respect to the proposed \$1,000,000 exemption; and (4) the inequitable nature of a fixed rate of taxation.

In place of the \$1,000,000 exemption proposed by the Treasury Department, this Bill would allow for a 20 percent deduction for generation-skipping transfers to lineal descendants of a parent of the decedent or other deemed transferor. The effect of this deduction would be to provide for a maximum tax on generation-skipping transfers to lineal descendants of a parent of the decedent or other deemed transferor (after 1987) equal to 40 percent (the tax rate proposed by the Treasury Department for all generation-skipping transfers). This maximum tax rate on generation-skipping transfers to lineal descendants of the grantor represents the underlying policy of the proposed Bill (and apparently that of the Treasury Department) that limited interests in property should not be taxed to the same extent as full interests. Unlike the present \$250,000 "grandchild's exclusion", this 20 percent deduction would not be limited by the number of children of the grantor, but would only be limited to the extent that the property is not distributed to lineal descendants of a parent of the decedent or other deemed transferor.

Since the generation-skipping transfer will simply be included in the decedent's estate or in the amount of the gifts made by a deemed donor (a separate return will not be required in either case), although, like percent chapter 13, the executor or deemed donor will not himself be required to pay the tax, and the tax attributable to the generation-skipping transfer will be postponed until the termination of the last interest of all persons in the particular generation.

Although the grantor of a generation-skipping trust under this proposal will suffer the loss of the Treasury's proposed \$1,000,000 exemption and the \$250,000 "grandchild's exclusion," he will be aided by the ability to utilize the deemed transferors' unified credits, by a 40 percent maximum tax rate on generation-skipping transfers to lineal descendants, and by the fact that direct transfers to grandchildren and more remote descendants, as well as distributions of income, will not be subject to either the estate or gift tax.

As an example of how this bill would operate, assume that a grantor creates a trust for the benefit of his three children and six grandchildren. In this situation, the death of a child at a time when the value of the trust corpus was \$1,000,000 would cause inclusion of \$333,333 ($\frac{1}{3} \times \$1,000,000$) in the child's gross estate under section 2047. If a second child dies when the value of the trust corpus has appreciated to \$1,333,333, \$500,000 ($\frac{1}{2} \times (\$1,333,333 - \$333,333)$) would be included in his gross estate under section 2047. In both cases, imposition of any tax resulting from the inclusion of such amounts in the children's gross estates would be postponed until the death of the third child. If, instead, a grantor creates three separate trusts for the benefit of each of his three children, with the remainder in each case to such child's own children, the full value of each separate trust corpus would be includible in the particular child's gross estate under section 2047 upon his death, and the tax would be payable with the return for the decedent rather than postponed until the death of the last child. Since only lineal descendants of a parent of the decedent are beneficiaries of the trusts described above, the full 20 percent deduction provided for under section 2057 would be available to each child's estate.

A BILL To amend the Internal Revenue Code of 1954 to repeal Chapter 13 of Subtitle B ("Tax On Certain Generation-Skipping Transfers") and substitute in lieu thereof estate and gift provisions relating to certain generation-skipping transfers

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. REPEAL OF TAX ON CERTAIN GENERATION-SKIPPING TRANSFERS.

(a) **IN GENERAL.**—The Internal Revenue Code of 1954 is amended by striking out chapter 13 of subtitle B (relating to tax on certain generation-skipping transfers).

(b) **EFFECTIVE DATE.**—The amendment made by this section shall be effective as of June 11, 1976.

SEC. 2. ADDITION OF NEW SECTIONS TO INTERNAL REVENUE CODE OF 1954.

(a) **INCLUSION OF CERTAIN GENERATION-SKIPPING TRANSFERS IN GROSS ESTATE.**—Part III of subchapter A of chapter 11 of subtitle B of the Internal Revenue Code of 1954 (relating to taxable estate) is amended by adding at the end thereof the following new section:

"SEC. 2047. CERTAIN GENERATION-SKIPPING TRANSFERS.

"(a) **IN GENERAL.**—The value of the gross estate shall include the value of property in which the decedent at the time of his death has a present interest (other than property which is included in the decedent's gross estate under sections 2033 to 2044, inclusive) if any person or persons assigned to a generation younger than that of the decedent have a present or future interest in such property immediately after the decedent's death.

"(b) **AMOUNT INCLUDIBLE.**—The amount includible under this section shall be equal to the value of the property in which the decedent at the time of his death has a present interest multiplied by a fraction, the numerator of which equals one (1) and the denominator of which equals the number of persons assigned to the same generation as that of the decedent (including the decedent) who had a present interest in such property immediately prior to the decedent's death.

"(c) **PAYMENT OF ESTATE TAX ATTRIBUTABLE TO INCLUSION UNDER THIS SECTION.**—

"(1) **GENERAL RULE.**—Except as otherwise provided in this subsection, and notwithstanding the provisions of sections 2002 and 6151, if any part of the gross estate consists of property the value of which is includible in the gross estate by reason of this section, the amount by which—

"(A) the total tax which is payable under this chapter, exceeds

"(B) the total tax under this chapter which would have been payable if the value of the decedent's interest in such property had not been included in the gross estate,

shall be payable by the person receiving the property at the time and place fixed for filing the federal estate tax return of the decedent (determined without regard to any extension of time for filing the return).

"(2) **DECEDENT MAY OTHERWISE DIRECT BY WILL.**—Paragraph (1) shall not apply if the decedent otherwise directs by will.

"(3) **TIME FOR PAYMENT OF TAX POSTPONED IN CERTAIN CASES.**—For purposes of determining the time when the tax as computed under paragraph (1) is payable, whether or not paragraph (1) applies, if, immediately after the decedent's death, another individual assigned to the same generation as that of the decedent has a present interest in the property an interest of which is includible in the decedent's gross estate under this section, which interest of such other individual would be includible in such other individual's gross estate under this section if such other individual died immediately after the decedent, the decedent shall be deemed to have died on the date of the subsequent termination, by death or otherwise, of the present interest of the last individual assigned to the same generation as that of the decedent to have an interest in such property which is includible in such individual's gross estate under this section or which is deemed to have been transferred by him under section 2515. If the interests of more than one individual in such property terminate simultaneously upon the happening of some event, the reference to the "individual" in this paragraph shall be to either of such individuals.

"(4) **DEFINITION OF PERSON RECEIVING THE PROPERTY.**—If the property is in a trust at the time of the decedent's death, the "person receiving the property" shall be either—

"(A) the trustee of the trust, or

"(B) any person who receives the property if the property does not remain in the trust, including the trustee of any other trust.

"(5) **MORE THAN ONE RECIPIENT OF PROPERTY.**—For purposes of this subsection, if there is more than one person receiving the property, the tax as computed

under paragraph (1) of this subsection shall be payable by each such person. This paragraph shall not affect the right, if any, under local law, of any person with an interest in property to reimbursement or contribution from another person with an interest in such property.

"(6) TAXES AND INTEREST.—In the case of penalties and interest attributable to the tax as computed under paragraph (1) of this subsection, rules similar to paragraphs (1), (2), (3) and (4) of this subsection shall apply.

"(d) DEFINITIONS OF INTEREST AND PRESENT INTEREST.—For purposes of this section—

"(1) A person has an "interest" in property if such person—

"(A) has the right to the possession or enjoyment of, or the income from, all or any portion of such property, or

"(B) is a permissible recipient of such income or property (including a potential appointee under a power of appointment held by another).

"(2) A person has a "present interest" in property if—

"(A) the interest is enforceable under governing law, or if it is subject only to the giving of notice, and if it is not contingent upon the happening of an event which is wholly outside of such person's control, or

"(B) such person may currently receive property or income therefrom upon the exercise of a trustee's or other person's discretion.

"(e) CERTAIN INTEREST NOT TAKEN INTO ACCOUNT.—

"(1) PROPERTY SUBJECT TO ESTATE OR GIFT TAX IN SAME GENERATION.—For purposes of this section, the decedent shall be treated as not having an interest in any property—

"(A) which property would be includible (other than under this section) in the gross estate of another individual in the same generation as that of the decedent if such other individual died immediately after the decedent (or, for purposes of sections 2515 and 2521, immediately after the termination of the deemed transferor's interest in such property),

"(B) which property is includible (other than under this section) in the gross estate of another individual in the same generation as that of the decedent which other individual died prior to the decedent (or, for purposes of sections 2515 and 2521, which other individual died prior to the termination of the deemed transferor's interest in such property),

"(C) to the extent the value of such property is includible under this section in the gross estate of another individual in the same generation as that of the decedent which other individual died prior to the decedent (or, for purposes of sections 2515 and 2521, which other individual died prior to the termination of the deemed transferor's interest in such property),

"(D) to the extent the previous transfer of such property was either includible under chapter 12 in the total amount of gifts made by another individual in the same generation as that of the decedent, or was excludible from the total amount of gifts made by such other individual under sections 2503 (b) or (e).

"(2) NOMINAL INTERESTS.—For purposes of this section, a person shall be treated as not having an interest in property if such person's interest is classified as nominal, as determined under regulations prescribed by the Secretary.

"(f) PROPERTY INCLUDES INTEREST THEREIN.—For purposes of this section, the term "property" shall include an interest in property.

"(g) SPECIFIC PORTION TREATED AS SEPARATE PROPERTY.—For purposes of this section, a specific portion of property shall be treated as separate property.

"(h) ASCERTAINMENT OF GENERATION.—For purposes of this section, the generation to which any person (other than the decedent) belongs shall be determined in accordance with the following rules:

"(1) An individual who is a lineal descendant of a great-grandparent of the decedent shall be assigned to that generation which results from comparing the number of generations between the great-grandparent and such individual with the number of generations between the great-grandparent and the decedent,

"(2) An individual who has been at any time married to a person described in paragraph (1) shall be assigned to the generation of the person so described and an individual who has been at any time married to the decedent shall be assigned to the decedent's generation,

"(3) A relationship by the half-blood shall be treated as a relationship by the whole-blood,

"(4) An individual who is not assigned to a generation by reason of the foregoing paragraphs shall be assigned to a generation on the basis of the date of such individual's birth, with—

"(A) an individual born more than 12½ years but not more than 37½ years before the date of the birth of the decedent assigned to the first generation higher than the decedent's generation,

"(B) an individual born not more than 12½ years before the date of the birth of the decedent and not more than 12½ years after the date of the birth of the decedent assigned to the decedent's generation,

"(C) an individual born more than 12½ years but not more than 37½ years after the date of the birth of the decedent assigned to the first generation younger than the decedent's generation, and

"(D) similar rules for a new generation every 25 years.

"(5) An individual who, but for this paragraph, would be assigned to more than one generation shall be assigned to the youngest such generation, and

"(6) If an estate or a trust, partnership, corporation, or other entity (other than an organization described in section 511(a)(2) and other than a charitable trust described in section 511(b)(2)), has an interest in property, each individual having an indirect interest power in the trust through such entity shall be treated as a person having an interest in the property and shall be assigned to a generation under the foregoing provisions of this subsection.

"(i) EFFECT OF ADOPTION.—For purposes of this section, a relationship by legal adoption shall be treated as a relationship by blood.

(b) ESTATE TAX DEDUCTION FOR CERTAIN GENERATION-SKIPPING TRANSFERS.—Part IV of subchapter A of chapter 11 of subtitle B of the Internal Revenue Code of 1954 (relating to taxable estate) is amended by adding at the end thereof the following new section:

"SEC. 2057. DEDUCTION FOR CERTAIN GENERATION-SKIPPING TRANSFERS.

"(a) AMOUNT OF DEDUCTION.—For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to 20 percent of the amount included in determining the value of the gross estate under section 2047 multiplied by a fraction, the numerator of which equals the number of lineal descendants of a parent of the decedent assigned to a generation younger than that of the decedent who have a present or future interest in such property immediately after the decedent's death, and the denominator of which equals the number of persons assigned to a generation younger than that of the decedent (whether or not lineal descendants of a parent of the decedent) who have a present or future interest in such property immediately after the decedent's death.

"(b) CERTAIN RULES MADE APPLICABLE.—For purposes of this section, rules similar to subsections (d) to (i), inclusive, of section 2047 shall apply.

(c) CERTAIN GENERATION-SKIPPING TRANSFERS DEEMED TRANSFERS OF PROPERTY FOR GIFT TAX PURPOSES.—Subchapter B of chapter 12 of subtitle B of the Internal Revenue Code of 1954 is amended by adding after section 2514 thereof the following new section:

"SEC. 2515. CERTAIN GENERATION-SKIPPING TRANSFERS.

"(a) IN GENERAL.—Unless otherwise treated as a transfer of property under this chapter, the termination of a deemed transferor's present interest in property (other than income), including a termination caused by the distribution of such property (free of such present interest) to an individual or individuals other than the deemed transferor, shall, if any person or persons assigned to a generation younger than that of such deemed transferor have a present or future interest in such property immediately after such termination, be treated as a transfer by such deemed transferor of all interests in such property other than the right to receive the income from such property or the right to such such property.

"(b) AMOUNT OF TRANSFER.—The amount of the deemed transfer under this section shall be equal to the value of the property in which such deemed transferor's present interest is terminated multiplied by a fraction, the numerator of which equals one (1) and the denominator of which equals the number of persons assigned to the same generation as that of such deemed transferor (including such deemed transferor) who had a present interest in such property immediately prior to such termination, reduced by the value, if any, of such deemed transferor's right to receive the income from such property or right to use such property.

"(c) DEFINITION OF DEEMED TRANSFEROR.—For purposes of this section, the term "deemed transferor" shall mean any person who has a present interest in property (disregarding section 2047(e)(1) which present interest is terminated (other than by death).

"(d) TRANSFER OF PRESENT INTEREST.—For purposes of section 2503(b) (relating to exclusions from gifts), any deemed transfer of property under this section shall be

treated as a transfer of a present interest in such property to the person or persons assigned to a generation younger than that of such deemed transferor who have a present or future interest in such property immediately after such deemed transfer.

"(e) SAME DEEMED TRANSFEROR HAS MORE THAN ONE PRESENT INTEREST.—In any case where a deemed transferor has more than one present interest in the property, the termination with respect to each such present interest shall be treated as occurring at the time when the last such termination occurs.

"(f) PAYMENT OF GIFT TAX ATTRIBUTABLE TO TRANSFERS UNDER THIS SECTION.—

"(1) GENERAL RULE.—Except as otherwise provided in this subsection, and notwithstanding the provisions of sections 2502(c) and 6151, if for any calendar year tax is payable under this chapter by reason of property treated as transferred by any person under this section, the amount by which—

"(A) the total tax which is payable for such calendar year under this chapter, exceeds

"(B) the total tax under this chapter which would have been payable if the value of such property had not been taken into account for purposes of this chapter,

shall be payable by the person receiving the property at the time and place fixed for filing the federal gift tax return of the deemed transferor for the calendar year in which such deemed transfer under this section occurs (determined without regard to any extension of time for filing the return).

"(2) TIME FOR PAYMENT OF TAX POSTPONED IN CERTAIN CASES.—For purposes of determining the time when the tax as computed under paragraph (1) is payable, if, immediately after the deemed transfer under this section, another individual assigned to the same generation as that of the deemed transferor has an interest in the property an interest of which is treated as transferred under this section, which interest of such other individual would be includible in such other individual's gross estate under this section if such other individual died immediately after the deemed transfer under this section, the deemed transfer under this section shall be deemed to have occurred on the date of the subsequent termination, by death or otherwise, of the present interest of the last individual assigned to the same generation as that of the deemed transferor to have an interest in such property which is includible in such individual's gross estate under section 2047 or which is deemed to have been transferred by him under this section. If the interests of more than one individual in such property terminate simultaneously upon the happening of some event, the reference to the "individual" in this paragraph shall be to either of such individuals.

"(3) DEFINITION OF 'PERSON RECEIVING THE PROPERTY'.—If the property is in a trust at the time of the deemed transfer under this section, the person receiving the property shall be either—

"(A) the trustee of the trust, or

"(B) any person who receives the property if the property does not remain in the trust, including the trustee of any other trust.

"(4) MORE THAN ONE RECIPIENT OF PROPERTY.—For purposes of this subsection, if there is more than one person receiving the property, the tax as computed under paragraph (1) of this subsection shall be payable by each such person. This paragraph shall not affect the right, if any, under local law, of any person with an interest in property to reimbursement or contribution from another person with an interest in such property.

"(5) TAXES AND INTEREST.—In the case of penalties and interest attributable to the tax as computed under paragraph (1) of this subsection, rules similar to paragraphs (1), (2), (3) and (4) of this subsection shall apply.

"(g) CERTAIN RULES MADE APPLICABLE.—For purposes of this section, rules similar to subsections (d) to (i), of section 2047 shall apply, with the term "deemed transferor" being substituted for the word "decedent" in every place in which such word occurs.

"(g) GIFT TAX DEDUCTION FOR CERTAIN GENERATION-SKIPPING TRANSFERS.—Subchapter C of chapter 12 of subtitle B of the Internal Revenue Code of 1954 is amended by adding before section 2522 thereof the following new section:

"SEC. 2521. DEDUCTION FOR CERTAIN GENERATION-SKIPPING TRANSFERS

"(a) AMOUNT OF DEDUCTION.—There shall be allowed as a deduction in computing taxable gifts for the calendar year an amount equal to 20 percent of the amount treated as a transfer property under section 2515 multiplied by a fraction, the numerator of which equals the number of lineal descendants of a parent of such deemed transferor assigned to a generation younger than that of such deemed trans-

feror who have a present or future interest in such property immediately after the termination of the deemed transferor's present interest in such property, and the denominator of which equals the number of persons (whether or not lineal descendants of a parent of such deemed transferor) assigned to a generation younger than that of such deemed transferor who have a present or future interest in such property immediately after such termination of the deemed transferor's present interest in such property.

"(b) CERTAIN RULES MADE APPLICABLE. —For purposes of this section, rules similar to subsections (d) to (i), inclusive, of section 2047 shall apply, with the term 'deemed transferor' being substituted for the word 'decendent in every place in which such word occurs.

(h) CONFORMING AMENDMENT. —Subchapter C of chapter 12 of subtitle B of the Internal Revenue Code of 1954 is amended by inserting "2521," before "2522" in section 2524.

(i) EFFECTIVE DATE. —The amendments made by this section shall in general apply with respect to the estates of decedents dying after December 31, 1984, and with respect to gifts made after such date. However, the amendments made by this section shall not apply to a present interest of a decedent or other deemed transferor in a trust which was irrevocable on December 31, 1984, but only to the extent the present interest is not in corpus added to the trust after December 31, 1984, or to a present interest of a decedent or other deemed transferor in property which arose pursuant to an irrevocable transfer of such property occurring on or before December 31, 1984.

SEC. 3. TECHNICAL CHANGES.

The Secretary of the Treasury shall, within 90 days after the date of enactment of this Act, submit to the Committee on Ways and Means of the House of Representatives, and to the Committee on Finance of the Senate, a draft of any technical and conforming changes in the Internal Revenue Code of 1954 which are necessary to reflect throughout such code the changes in the substantive provisions of law made by this Act.

VALENSI & ROSE,
Los Angeles, CA, July 23, 1984.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Building, Washington, DC.

DEAR MR. SALMON: I am a tax and estate planning attorney in Los Angeles. It is my belief that a generation-skipping transfer tax achieves "essential fairness". Unfortunately, neither the 1976 generation-skipping transfer tax nor the one proposed by the Treasury Department is workable. In fact, it is my opinion that a generation-skipping transfer tax is not workable in any possible form.

The only people who will intentionally utilize generation-skipping techniques are the very wealthy. Of the three families I represent having estates of at least \$30 Million, only one of them has set up a generation-skipping trust. The other two did not wish to permanently control disposition of their estate.

On the first death of a husband or wife, assets equal in value to the exemption equivalent amount will either pass to a bypass trust, or in the case of the wealthy, it will more likely go outright to adult children. The remainder is left either outright or in some form of qualifying trust for the benefit of the surviving spouse. At the time of the death of the first spouse, the estate plan has made sure that no estate taxes are payable. Upon the death of the surviving spouse, death taxes are paid on both halves of the estate (less the assets which represented the exemption equivalent amount on the death of the first spouse). It is a fear of Congress that upon the death of the children or grandchildren, the generation-skipping trust will not be taxed even though their estates have had virtually free use of the assets during a portion of their lifetimes.

There are two ways in which the generation-skipping transfer scheme can be somewhat curtailed. First of all, the rule against perpetuities statutes in every state restrict the number of generations that can be skipped. Secondly, I would propose a permanent postponement of the reduction of the top estate tax bracket from 55% to

50%. The extra 5% tax rate would probably produce more tax dollars than the generation-skipping transfer tax. In addition, it hits the estate at the first possible point of generation-skipping transfer and has the overall effect of reducing the amount that will pass to the grandchildren, great-grandchildren, and so forth.

I just wanted to add my thoughts to your files.

Very truly yours,

JONATHAN A. BROD.

TEXAS A&M UNIVERSITY,
COLLEGE OF BUSINESS ADMINISTRATION,
College Station, TX, September 27, 1984.

MR. JOHN J. SALMON,
*Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth
House Office Building, Washington, DC.*

DEAR MR. SALMON: Enclosed are six copies of a revised version of a paper by Professor Bravenec and I titled "An Accessions Emphasis for Federal Estate and Gift Taxes." This paper is a revision of an earlier paper with the same title sent to you by Professor Bravenec.

The enclosed paper is our testimony for the Generation-skipping Transfer Tax hearings. Please consider the paper in connection with the debate on the Generation-skipping Tax and for inclusion in the printed record of the committee hearing on that subject. Tax Notes has given us their permission to submit the paper for such inclusion.

If we can be of further assistance, please let us know.

Sincerely,

DENNIS R. LASSILA, Ph.D., CPA,
Graduate Tax Faculty.

Enclosure.



AN ACCESSIONS EMPHASIS FOR FEDERAL ESTATE AND GIFT TAXES

by **Lorence L. Bravenec**
and **Dennis R. Lassila**

Professor Lorence L. Bravenec and Professor Dennis R. Lassila are members of the Graduate Tax Faculty, Texas A&M University, College Station, Texas.

In this article, the authors propose an accession tax emphasis in the present estate and gift tax system to deal with the problem of generation-skipping transfers. Under their proposal the present generation-skipping transfer tax system would be repealed and the present estate and gift tax system modified. Deductions of up to 100 percent would be granted for qualified transfers to certain persons while transfers in trust would not qualify for any deduction unless the transfer is considered the equivalent of full ownership.

The article also compares the accessions emphasis proposal to the present generation-skipping transfer tax system, the Treasury Department's generation-skipping tax proposal and the ALI Discussion Draft proposal.

I. INTRODUCTION

The problem of generation-skipping transfers is well recognized and has received wide attention in recent years.¹ In 1976 Congress enacted a comprehensive set of rules to govern the taxation of generation-skipping transfers. Unfortunately, the present generation-skipping transfer (GST) tax system is generally regarded to be complex and sometimes acts as a trap for the unwary. As noted in a recent article by Consuelo Kertz,² the many statutory definitions of the GST system put a premium on careful planning, and the absence of final regulations and decided case law add to the uncertainty of the practitioner and the IRS alike. While the well-advised taxpayer can generally avoid the GST tax by techniques such as "layering" his estate and making direct transfers to younger generation beneficiaries, the ill-advised taxpayer may inadvertently be faced with the GST tax because a beneficiary has a contingent interest or because a related

trustee has overly broad administrative powers. Consequently, there have been many calls for reform or outright repeal of the present GST tax system.

The Senate version of the Tax Reform Act of 1984 (TRA) contained a provision sponsored by Senator Steven Symms, R-Idaho, which would have retroactively repealed the GST tax.³ However, the House version of the TRA contained no GST tax provision.⁴ Apparently feeling that it would be inappropriate to eliminate the GST tax provisions without adopting an alternative system, the Conference Report on the TRA did not include the Senate provision.⁵ Thus, the present GST tax system continues to be the law. However, these actions should not be interpreted as a signal that the law will not be changed or eliminated in the near future. On October 2, 1984, the House Ways and Means Committee will hold hearings on proposals to simplify and/or eliminate the GST tax. Among the proposals that will be evaluated is a proposal advanced by the Treasury Department that will change, rather than reform, the GST tax system.⁶ The Ways and Means Committee will also review the recent American Law Institute (ALI) Discussion Draft proposal to change the taxation of GST.

We believe that none of the above alternatives represent a satisfactory way to handle the problem of generation-skipping transfers. Instead, we feel that an accession

¹Senate Report No. 98-169, 98th Cong., 2d Sess., 716 (1984).

²H.R. Report No. 98-432, 98th Cong., 2d Sess. (1984).

³H.R. Report No. 98-861, 98th Cong., 2d Sess., 1237 (1984).

⁴Letter from John E. Chapoton, Assistant Secretary for Tax Policy, to Sen. Steven D. Symms (R-Idaho), Chairman, Senate Finance Subcommittee on Estate and Gift Taxation, with Proposal on Generation-Skipping Transfer Tax, issued April 29, 1983. The proposal has subsequently been presented in draft bill form.

⁵American Law Institute, "Federal Estate and Gift Tax Project Study on Generation-Skipping Transfers under the Federal Estate Tax Discussion Draft No. 1" (March 28, 1984).

An accessions tax is an excise tax on the transfer of money and property by gift or on death, but it is imposed on the recipient of the property . . .

¹See for example, American Law Institute, *Federal Estate and Gift Taxes* 1968 and the Joint Committee Report on the Tax Reform Act of 1976, H.R. 10612, 94th Cong., 2d Sess., 564 (1976).

²Kertz, Consuelo, "A Comparison of the Current Generation-Skipping Transfer Tax and the Recent Treasury Proposal," *Tax Notes*, October 31, 1983, p. 363.

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emphasis in the present estate and gift tax system would more fairly and equitably deal with the problem of generation-skipping transfer. What follows is a description of our proposal for an accessions emphasis to the present estate and gift taxes and a comparison of the proposal with the present GST tax system, the Treasury's GST tax proposal and the ALI Discussion Draft Proposal. (It should be noted that in place of the suggested accessions emphasis approach for the present estate and gift taxes, there could be a separate accessions tax or flat rate surcharge based on principles discussed herein.)

II. THE ACCESSIONS EMPHASIS PROPOSAL

An accessions tax is an excise tax on the transfer of money and property by gift or on death, but it is imposed on the recipient of the property or property interest rather than on the donor or the decedent's estate.¹ In this sense the accessions tax is similar to state inheritance taxes which are imposed on the recipients of inheritances, while transfer taxes such as the present federal estate and gift taxes are imposed on the transferor of inheritances and gifts and have a base measured by the total amount of gratuitous transfers made by the donor-decedent.

One of the arguments supporting an accessions tax system is that the tax is imposed on the persons who benefit the most from receiving property gratuitously, the transferees.

An accessions tax system was first proposed by Professor Harry Rudick in 1945 as a complete substitute for the then existing federal estate and gift tax system.² Subsequently, Professor William Andrews proposed an accessions tax system as a "Reporter's Study" as part of American Law Institute's 1968 publication on federal estate and gift taxation.³ Andrews also proposed the accessions tax as a replacement for the federal estate and gift tax system. One of the arguments supporting an accessions tax system is that the tax is imposed on the persons who benefit the most from receiving property gratuitously, the transferees. The transferees also ultimately bear the burden of a transfer tax anyway. On the other hand, a significant problem under Andrews' accessions tax proposal is the handling of transfers in trust. If estate and gift taxes were eliminated, no tax would be imposed until distributions were made from the trust. Thus, tax under an accessions system could be postponed for years by not making any distributions from the trust.⁴

We propose an accessions emphasis to the present federal transfer tax system, with the following changes:

1. The present GST system would be repealed, but the present estate and gift tax system would be modified.

2. Deductions, generally 100 percent and 50 percent, would be granted in the case of qualified transfers to certain persons, and the estate and gift tax rates would be raised and/or the unified credit lowered to make up for any lost revenue.

3. Transfers in trust (and other transfers of less than full ownership) would not qualify for any deduction unless considered to be the equivalent of a transfer of full ownership.

The deduction (No. 2) will give the estate and gift taxes an accessions tax emphasis, in that qualified transfers giving rise to a 100 percent deduction would be subjected to no tax and those giving rise to a partial deduction would be subjected to preferred treatment. However, this approach does not substitute a pure accessions tax, as the amount of tax is still based on the decedent-donor's total transfers (after deductions) to all transferees.

Further, the treatment of trusts (No. 3) will be the replacement for the present GST system. Also, the new system will build on the present estate and gift tax system, thus making use of the widespread knowledge of this system.

Determining the Deduction on Transfers of Full Ownership or Its Equivalent

In determining the amount of deduction permitted for certain transfers under the modified estate and gift tax system, it is necessary to distinguish between the following groups of persons when there is a transfer from the donor-decedent of full ownership or its equivalent (the concept of full ownership equivalent is covered later):

Group I: The No Tax Group. Transfers to or for the benefit of persons in Group I would not be subject to a transfer tax if the transfer is of full ownership or its equivalent. This group would be identified largely in relation to the donor-decedent. Under the present estate and gift tax system, only transfers to the spouse of the donor-decedent and charitable beneficiaries are exempt from tax. However, Group I could be expanded so that one or more additional classes of generations above that of the donor-decedent could be exempted from transfer taxes, such as ancestors, aunts, and uncles. Group I could also be expanded to include persons in the same generation as that of the donor-decedent, such as brothers, sisters, and cousins.

Group II: The Preferred Tax Group. Transfers to or for the benefit of persons in Group II would be only partially taxed if the transfer is of full ownership or its equivalent. This group would also be identified generally in relation to the donor-decedent.

Group II would include children of the donor-decedent and other persons who are not more than one generation below that of the donor-decedent. It would cover grandchildren and descendants belonging to lower generations only in limited situations such as when intervening generations are deceased at the time of the transfer.

⁴It would also be possible, in place of a deductions approach, to apply a flat rate accessions surtax on transfers which would not qualify for the deduction as described herein. See note 14.

¹Andrews, William D., "Reporter's Study of the Accessions Tax Proposal," in American Law Institute, *Federal Estate and Gift Taxes*, 1968, p. 446.

²Rudick, Harry, "A Proposal for an Accessions Tax," *Tax Law Review*, Vol. 1 (1945), p. 25.

³See Note 8.

⁴See Andrews, Note 8.

⁵To deal with this problem, Andrews proposed a "special estate tax" to apply to transfers made in trust of \$500,000 or more.

Group III: The Full Tax Group. Transfers to a natural person within Group III of an ownership interest or its equivalent would be fully taxed. The full-tax group would include grandchildren and great-grandchildren of the donor-decedent and other persons who are more than one generation younger (as defined under the present GST tax provisions) than the donor-decedent.

As mentioned earlier, transfers to persons belonging to Group I would not result in an estate or gift tax if the transfer is of full ownership or its equivalent. A 100 percent deduction would be provided for such transfers, thereby exempting covered transferees from tax. Although an exclusion for such transfers would also exempt the transferees, the 100 percent deduction approach is best because it is currently used to shield transfers to the spouses of donor-decedents and to charitable organizations from transfer taxes.

Transfers to persons belonging to Group II would result in a partial tax. The preferable mechanism would be to grant a deduction of perhaps 50 percent on transfers to persons in Group II (with no deduction permitted on transfers to members of Group III).¹⁴ Further, Group II could be broken into subgroups and a different deduction percentage (e.g., 40 percent and 60 percent) applied to each if it is desired, to distinguish among different degrees of kinship to the decedent.

Definition of Equivalent of Full Ownership Interest. Interests in trust or otherwise that are considered to be the equivalent of full ownership must be defined. In this connection, transfers giving rise to an automatic marital deduction (i.e., the estate trust and the life interest with general power of appointment trust) under the present estate and gift tax system could be used as two types of full ownership equivalents. For that matter, the mere possession of a general power of appointment should be considered a full ownership equivalent under the proposal (although this result is not indispensable), because the proposal seeks to build on the concepts and approaches of existing law. Further, certain interests could be considered the equivalent of full ownership at the election of the parties.¹⁵ For example, the concept of the

qualified terminable interest transfer could be borrowed from the present marital deduction.

The following examples illustrate the determination of transfer tax on transfers of full ownership or equivalent interests.

Example 1. In 1985, Blake, who is not married, makes a gift of some land to his father. The value of the land is \$1,800,000. The transfer will not be subject to any gift tax because a 100 percent deduction would be allowed in computing the amount of the gift subject to tax. Blake's father is a member of Group I, the No-Tax group.

Example 2. Assume the same facts as in example one except that the land is given to Blake's son and that Blake had not given any previous taxable gifts. Using rates currently in effect and applying current law, Blake would be liable for a gift tax of \$183,050, computed as follows:

Gross Gift	\$1,800,000
Minus Annual Exclusion	-10,000
Gift (Net of Annual Exclusion)	\$1,790,000
Minus 50 percent deduction	-895,000
Taxable Gift	\$ 895,000
Gift Tax	\$ 304,850
Minus Unified Credit	-121,800
Gift Tax Liability	\$ 183,050

Note that the 50 percent deduction is permitted because the son is a member of Group II, The Preferred Tax Group.

Example 3. Assume the same facts as in example two except that the land is given to Blake's grandson at a time when his parents are alive. Blake would be liable for a gift tax of \$564,500, computed as follows:

Gross Gift	\$1,800,000
Minus Annual Exclusion	-10,000
Taxable Gift	\$1,790,000
Gift Tax	\$ 686,300
Minus Unified Credit	-121,800
Gift Tax Payable	\$ 564,500

No deduction is permitted on the transfer to Blake's grandson because the grandson is a member of Group III, The Full Tax Group.

Example 4. Assume that instead of making an outright gift of the land, Blake transfers the land in trust for the benefit of his son, giving the son a general power of appointment over the land. The amount of gift tax payable would be the same as calculated in example two because the transfer is of a full-ownership equivalent and the son is a member of Group II, The Preferred Class. If the transfer had been made for the benefit of Blake's father, no gift tax would have been payable—see example one.

Example 5. Assume the same facts as in example four except that the transfer is made for the benefit of Blake's grandchild. Blake would have to pay a gift tax of \$564,500 (see calculations in example three) because no deduction is allowed on the transfer.

¹⁴An alternative approach, which recognizes the interdependence of treatment of Groups II and III, would be to tax transfers to members of each group at regular rates under the present estate and gift tax system and to impose a flat rate accessions surtax (e.g., at 40 percent) payable by the donor or the decedent's estate on transfers to persons in Group III in excess of an exemption amount (e.g., \$300,000). The use of a flat rate would preclude the need to calculate a tax based on cumulative taxable accessions but, because of the exemption, the scheduled average rates would still be somewhat progressive. However, the accessions surtax would probably be less acceptable politically than the deductions approach.

¹⁵The proposal is flexible enough so that the concept of a full ownership equivalent could be elected in many kinds of situations.

For example, a parent creates a trust for the benefit of child X during her life, followed by a life interest in another child Y during his life, followed by a life interest in a grandchild Z, and then followed by a remainder interest in Z's children. It could be possible to create an election by X to treat the property as being gifted outright to her, so that the initial transfer in trust is to a Group II member and so that on X's death a transfer is considered as made by X, at which time Y could be given a similar election.

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Determination of Tax on Transfer of Interests Which Are Not the Equivalent of Full Ownership

Transfers in generation-skipping trusts and other generation-skipping arrangements which are not considered to be the equivalent of full ownership will be subject to federal estate or gift taxes at the time of the transfer. The tax would be computed on the fair market value of the property transferred using applicable estate and gift tax rates. In effect, the trust or other arrangement would be treated as a person in Group III.¹⁴ (Hereinafter, these trusts and other arrangements will be known as "Group III trusts.")

Subsequent Transfer of Full Ownership Interest. When there is a subsequent transaction in which an individual receives full ownership or its equivalent over some portion of the Group III trust (as by a transfer from the trust), the trust's transfer tax liability (if any) would be determined as follows for the following groups of beneficiaries:¹⁵

Groups I and II. A transfer by the trust to an individual belonging to Group I or II would not be subject to any transfer tax on such a transaction; that is, there would be a 100 percent deduction. This approach is in recognition that full taxation (with no deduction) was imposed on the transfer to the trust, even though there was a potential Group I or II beneficiary.

Group III. A transfer to a member of Group III would be subject to a partial tax if it took place within 25 years of the date of the prior completed transfer by the donor-decedent; it would be subject to full tax if made after the expiration of that 25-year period.¹⁶ Alternatively, the transition from partial to full tax on transfers to members of Group III could be phased in gradually. For example, if a deduction of 50 percent were provided for partial taxation, the deduction could be decreased by two percentage points for each complete year following the prior completed transfer to the trust.

The following are examples of events which could be considered a transfer of full ownership interest by a Group III trust:

- a) The lapsing of a general power of appointment resulting in a beneficiary's having a full ownership equivalent.

¹⁴A similar approach was used in the American Law Institute's Federal Estate and Gift Tax Project Study on Generation-Skipping Transfers under the Federal Estate Tax: Discussion Draft No. 1 (March 28, 1984).

¹⁵For this purpose, all Group III trusts created by the same grantor are to be treated as one trust. Thus, if a grantor created three Group III trusts, the transfer tax on a gratuitous transfer made to a natural person within Group III would be determined as follows:

- (i) Calculate the transfer tax on the sum of that taxable transfer plus all previous transfers made by all Group III trusts created by the same grantor; and

- (ii) Subtract the amount of transfer tax on all previous transfers by the Group III trusts to members of Group III.

Notice that the method of calculating such transfer tax is the same as that used to calculate gift taxes under current law (section 2502). No annual exclusions would be permitted, however.

¹⁶See note 17.

- b) The termination of a life estate when there are not intermediate estates; or
- c) The distribution of principle from a trust.¹⁷

The imposition of only a partial tax on transfers to persons in Group III within 25 years after the prior completed transfer by the donor-decedent is in recognition of the fact that a full transfer tax was paid within the previous 25 years on the property. We feel that transfers within the first 25 years do not have the generation-skipping potential of transfers after 25 years.

The new system will build on the present estate and gift tax system, thus making use of the widespread knowledge of this system.

It will be necessary to aggregate all transfers by Group III trusts created by the same donor-decedent.¹⁸ Otherwise, there would be an incentive to create multiple trusts in order to have the benefit of lower incremental rates and of the unified credit.

The following examples illustrate the application of the calculation of the transfer tax on transfers into and out of Group III trusts:

Example 1. Suppose that in 1985, Anderson, a widower, creates two trusts. The first trust is to pay income to his son, Bill, for life with the remainder to Anderson's grandson, Mark. The second trust is to pay income to Anderson's son, Bob, for life with the remainder to Anderson's grandson, Ted. Blank Bank is the trustee for each trust, and as trustee it has the right to invade principal in each trust for the benefit of the life tenant and/or remainderman. Anderson transfers property worth \$1,000,000 into each trust. He has made no previous taxable gifts. Both trusts are not considered to be an equivalent of full ownership. Each trust is a Group III trust and Anderson will pay a transfer tax of \$650,000 on the transfer (after subtracting the \$121,800 unified credit on creation of the trusts).

Example 2. Continuing the facts of example one, suppose that after eight years, in 1993, the first trust distributes \$225,000 of corpus to the son, Bill. There will be no transfer tax on the transfer because while the transfer is of full ownership equivalent, there is a 100 percent deduction permitted for such transfers out of a Group III trust to an individual belonging to Group I or Group II.

Example 3. Continuing the facts of example one, suppose that in 1997, the trustee pays \$700,000 out

¹⁷The distribution of income from a Group III trust could also be considered a transfer of a full ownership interest by the trust. However, a deduction or tax credit for the amount of transfer taxes paid should be provided in determining the transferee's income tax on the distribution. This would partially or totally alleviate the problem of double taxation on income distributions from trusts which are subject to both transfer and income taxes.

¹⁸See note 17.

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of corpus to the grandson, Mark, from the first trust. The first trust would be liable for a transfer tax of zero, computed as follows:

Gross Amount of the Transfer	\$700,000
Minus 50 percent deduction applying to the transfer	-350,000
Taxable Transfer	\$350,000
Transfer Tax	\$104,800
Minus Unified Credit	-192,800
Transfer Tax Payable	\$ 0

The transfer tax is zero due to the fact that a 50 percent deduction was permitted in computing the taxable amount of the transfer. The 50 percent deduction was permitted because the transfer was made within 25 years of the date the trust was created.

Example 4. Continuing the facts of examples one through three, assume that in the year 2012 (27 years after creation of the trust), Anderson's son, Bob, dies. At that time, the assets of the second trust, worth \$3,000,000, pass to the remainderman, grandson Ted. Further assume that this is the first transfer to a grandson since the one described in example three above. Assuming that present transfer tax rates will be applicable in the year 2012, the trust will pay a transfer tax of \$1,258,000 on the transfer, computed as follows:

Transfer tax on the three million dollar transfer plus the previous \$350,000 taxable transfer	\$1,450,800
Minus Transfer Tax on \$350,000 previous transfer	-104,800
Tax on \$3,000,000 transfer	\$1,346,000
Minus Unused Portion of Unified Credit (\$192,800 - \$104,800)	-88,000
Transfer Tax Payable	\$1,258,000

Note that since the transfer occurs more than 25 years after the creation of the trust it is fully taxable. Further, the transfer is aggregated with the previous taxable transfer made from trust one for purposes of calculating the tax.

III. SUMMARY OF THE ACCESSIONS EMPHASIS PROPOSAL

The following is a general summary of our accessions tax proposal:

1. The present estate and gift tax system would be retained, but modified.
2. The present GST tax system would be repealed.
3. Transfer tax for Transfers of Full Ownership and the Equivalent of Full Ownership:
 - Group I—No tax
 - Group II—Partial tax
 - Group III—Full tax
4. Transfer tax for Transfers of Other Than Full Ownership and the Equivalent of Full Ownership:
 - a) Into a trust or other arrangement—generally subject to full transfer taxes to decedent/donor computed under present estate and gift tax rules (as if made to a Group III beneficiary).
 - b) Out, that is a subsequent transfer of full ownership or its equivalent from the trust or other arrange-

ment—subject to full transfer taxes to the trust as follows:

Group I and II—No tax (i.e., a 100 percent deduction for a transfer to members of Group I and II).

Group III—partial tax (e.g., a 50 percent deduction for a transfer to members of Group III) if transfer is within 25 years of the prior completed transfer in trust.

Group III—full tax if transfer is 25 or more years after the prior completed transfer in trust.

IV. COMPARISON OF ALTERNATIVES

Consuelo Kert's article covered the main aspects of and differences between the present GST tax system and the Treasury proposal.² This part of the article compares some of the major distinctions between our accessions emphasis proposal and the present GST tax system, the Treasury proposal, and the ALI Discussion Draft Proposal.

Transfers in generation-skipping trusts and other generation-skipping arrangements which are not considered to be the equivalent of full ownership will be subject to federal estate or gift taxes at the time of transfer.

The Present GST Tax System and the Treasury Proposal

The accessions emphasis proposal differs from both the current GST tax system and the Treasury proposal in three fundamental ways. First, the accession emphasis proposal gives explicit recognition to the desirability of the effective transfer tax rate having a relationship to the class of beneficiary, i.e., it has an accessions emphasis, while the current GST tax system and the Treasury proposal do not. Secondly, the accessions emphasis proposal also differs from the other two approaches in discouraging long-term trusts and other arrangements for Group III beneficiaries by reducing the amount of taxes paid on a distribution from a Group III trust or arrangement to a Group III beneficiary if the distribution occurs within 25 years of the prior completed transfer into the Group III trust or other arrangement. Neither the present GST system nor the Treasury proposal distinguishes between the treatment of transfers based upon their timing. Thirdly, the accessions emphasis proposal differs from the present GST system and the Treasury proposal in that the accessions emphasis proposal is merely a proposed change in the way estate and gift taxes will be determined for particular gratuitous transfers. This eliminates the need for an additional set of rules to apply to GS transfers. As such, the accessions emphasis proposal would result in a much needed simplification of the transfer tax rules overall. In contrast, under the present GST system and the Treasury proposal, an additional set of rules is used to determine the tax consequences of GS transfers.

² See Kert's note 2.

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The Present GST System

The accessions emphasis proposal also differs from the present GST tax system in two additional ways.²² First, the accessions emphasis proposal would be applicable to both direct and indirect generation-skipping transfers whereas the present GST tax system applies only to transfers made through generation-skipping trusts or their equivalents (that is, indirect transfers). The proposal thus would affect "layering" and would eliminate one of the most serious shortcomings of the present GST tax system—the failure to deal with direct GS transfers.

Under the present . . . tax system, it is difficult to ascertain the tax rate(s) that will apply to the transfer.

Another difference is that the accessions emphasis proposal would not be based on the transfer tax position of some deemed transferor, having no necessary relationship to the taxed transfer, as under the GST tax system. Under the present GST tax system, it is difficult to ascertain the tax rate(s) that will apply to the transfer. In the case of the accessions proposal, gratuitous transfers of full ownership or their equivalent are taxed to the transferor, at a rate based on the class of beneficiary involved. The transferor is also subject to taxation on the gratuitous transfer of interests of less than full ownership in trust or similar arrangements (Group III trusts or arrangements). Finally, Group III trusts or arrangements pay a transfer tax on transfers of full ownership or their equivalent to beneficiaries belonging to Group III, but not to beneficiaries belonging to Group I or Group II.

The Treasury Proposal

The main additional difference between the Treasury's GST tax proposal and the accessions proposal is that under the Treasury proposal, each grantor is entitled to make up to \$1 million of cumulative lifetime and testamentary generation-skipping transfers without incurring a GST tax. Thus, under the Treasury proposal all but quite wealthy grantors will escape coverage. Under the accessions emphasis proposal, there is no comparable exemption or exclusion.

The ALI Discussion Draft Proposal

The ALI Discussion Draft Proposal for taxing GS transfers is much more like the accessions emphasis proposal than the present GST tax system or the Treasury proposal.²³ For example, the ALI proposal is primarily based

on a distinction between the treatment of "owned" trusts and "non-owned" trusts. The definition of an "owned" trust under the ALI proposal is very similar to the definition of a trust which is the equivalent of a transfer of full ownership under the accessions emphasis proposal. Likewise, "non-owned" trusts for ALI proposal purposes are similar in definition to trusts which are not the equivalent of full ownership (the Group III trust or arrangement) under the accessions emphasis proposal. Further, this second kind of trust is treated as a separate transfer tax taxpayer under both proposals. The ALI proposal and the accessions emphasis proposal are also alike in providing for taxation of outright GS transfers.

However, there are some significant differences between the ALI and accessions emphasis proposals. The following are the major differences between the two:

1. The ALI proposal would repeal the provisions of sections 2041 and 2514 covering the transfer tax treatment of general powers of appointment. The accessions emphasis proposal, in contrast, builds on the present estate and gift tax system and thus would treat general powers of appointment as equivalent to full ownership unless there were some compelling reason for repealing or modifying present law.

2. The proposals treat outright GS transfers differently. Under the ALI proposal, an outright GS transfer is one which is made by an individual or an owned trust to grandchildren or more remote descendants, to nonrelated individuals more than 35 years younger than the grantor, or to an owned trust for the benefit of such persons, but does not involve a transfer to a "non-owned" trust. The ALI proposal would impose a special surtax on outright GS transfers, a proposal which is both complex and politically weak. In contrast, the accessions emphasis proposal treats outright GS transfers as Group III transfers in subjecting them to a full tax and in not granting them preferential treatment. This latter proposal is simpler and more politically acceptable than the surtax. Moreover, it has the significant advantage of building on existing law.

The ALI proposal would impose a special surtax on outright generation-skipping transfers, a proposal which is both complex and politically weak.

3. The two proposals also differ in their treatment of distributions by "non-owned" (Group III) trusts. Gratuitous transfers by "non-owned" trusts (Group III trusts) to grandchildren and other persons more than one generation below that of the grantor are subject to transfer taxes under both proposals. Under the ALI proposal such transfers are taxed to the trust at the maximum marginal transfer tax rate in effect at the time of the transfer, and a special GS transfer tax credit of up to \$417,000 (based on transfer tax rates expected to be applicable in 1988) per grantor is available to offset such tax. Further, a transfer tax at the highest marginal rate is applied to the fair market value of the trust corpus upon a "taxable termination" of the trust, similar to the current law's definition of taxable terminations under section 2613.

²²Another difference is that the present GST Tax System gives a \$250,000 exclusion per deemed transferor for GS transfers to grandchildren of the grantor. Under the accessions emphasis proposal, no exemption or exclusion would be permitted for gratuitous transfers to grandchildren of the grantor. However, this difference is not significant, because the \$250,000 exclusion could easily be taken out of the present GST system or added to the accessions emphasis proposal.

²³American Law Institute, "Federal Estate and Gift Tax Project Study on Generation-Skipping Transfers under the Federal Estate Tax Discussion Draft No. 1" (March 26, 1984).

Under the accessions emphasis proposal, on the other hand, transfers by a Group III trust of full ownership equivalent to a grandchild or other beneficiary more than one generation below the grantor subjects the trust to the regular transfer tax at the time of the transfer, and the unified credit is allowed. No special generation-skipping credit is created. Further, there is no taxable termination provision under the accessions emphasis proposal. Instead, GS transfers made by the trust within 25 years after the creation of the trust are only partially taxed, while GS transfers made after 25 years are fully taxed.

It seems unduly harsh to fully tax transfers to non-owned trusts as if the trust were a separate transfer tax taxpayer and then to impose another full tax upon a subsequent distribution by the trust to a grandchild of the grantor.

It seems unduly harsh to fully tax transfers to "non-owned" trusts as if the trust were a separate transfer tax taxpayer and then to impose another full tax upon a subsequent distribution by the trust to a grandchild of the

grantor, regardless of the time interval between the creation of the trust and the distribution. The accessions emphasis proposal recognizes the relevance of this time interval by imposing only a partial tax if there is a distribution to a Group C beneficiary within 25 years of the creation of the trust.

The ALI proposal is also unduly complicated by its deemed distribution rules, which could be triggered by the death of all members of an intervening generation. It is politically weak because Congress should realize that such an event could escape notice and could create taxpayer resentment at the time the tax is imposed. The accessions emphasis proposal, on the other hand, focuses on distributions, events which are less likely to escape notice or to create taxpayer resentment. At the same time, the accessions tax proposal encourages early distributions by making the amount of tax dependent on the length of time between the creation of the trust and the distribution.

V. CONCLUSION

The accessions tax proposal would deal effectively with generation-skipping transfers, would greatly simplify the determination of tax on GS transfers, and would be imposed differentially depending upon the status of the beneficiary relative to the donor-decedent. This proposal has the added advantage of working within the present established estate and gift tax system, and eliminates the need for a separate tax system for GS transfers.

Addition to Accessions Emphasis Proposal
Professors Lorence L. Bravenec and Dennis R. Lassila

Re: The Generation Skipping Transfer Tax

The Connecticut State Bar Association ("Bar Association") has presented testimony calling for replacement of the generation-skipping transfer tax with a "Wrap-Around Accessions Tax." At the same time, the Bar Association has criticized the Accessions Emphasis proposal (attached) as being "far more complex" than their Wrap-Around Accessions tax proposal. This criticism is not well founded. Indeed, the Wrap-Around Accessions Tax proposal would add a new tax system (in place of the generation-skipping transfer tax system) on top of the present uniform transfer tax system (estate and gift taxes) as follows: (1) an accessions tax to be applied to certain generation-skipping transfers and (2) a supplemental "flat tax" on certain "long-term" trusts along with a related non-refundable tax credit.

In contrast, the Accessions Emphasis proposal would eliminate the present generation-skipping tax without adding another tax system on top of the existing estate and gift tax system. Instead, the proposal merely provides that generation-skipping transfers will incur a larger estate or gift tax than other gratuitous transfers. The mechanism for implementing the increased tax will be a system of deductions (probably 100% and 50%), based largely on concepts already developed in Sections 2044, 2056, and 2523, coupled with an increase in rates. This will result in a higher burden on generation-skipping transfers and a lower burden on other gratuitous transfers. There is no call for a substantial revision of estate and gift tax laws as the Bar Association asserts. Thus, current estate and gift tax laws would remain almost completely unchanged, and there would be no need for an additional or supplemental tax system to deal with the generation-skipping problem.

It is relatively easy to demonstrate the comparative simplicity of the Accessions Emphasis proposal, through drafting of the alternatives. The ALI and the Treasury proposals have already been drafted. This procedure could also be applied to the Accessions Emphasis proposal and the Wrap-Around Accessions Tax.

In summary, as noted in the Accessions Emphasis paper, the Accessions Emphasis proposal is the least complex and the best alternative to the present generation-skipping tax system.

STATEMENT OF DAVID N. MILLS, CROSS, WROCK, MILLER & VIESON

As a tax practitioner, I have no major objections to the existing GSTT, and find it workable, although rather complicated, and unless it is to be repealed altogether, my only recommendation as to same would be to increase substantially the \$250,000 exemption contained in Section 2613(b)(6).

The two above referenced new proposals would each represent a somewhat simpler approach, but either of them would also constitute an unwarranted extension of the existing law which, despite the relatively generous exemptions proposed therein, would result in even greater total taxes becoming payable than under the present GSTT provisions in a vast number of very unfair situations, as a result of the fact that they would impose the GSTT on any outright transfer of property to a grandchild or other second generation member, even where no child or other first generation member has or ever had an interest in such property.

The only possible rationale for applying a second or "penalty" tax to direct transfers to a grandchild of property in which its parents have no interest, and regardless of the amount of each specific transfer, is that a child upon his death (or theretofore) should be taxed on whatever his parent owned, regardless of whether he ever received any part of it from his parent, and indeed, regardless of whether or not he even survived his parent. If we are going to change our entire tax system to one which taxes all individual wealth or capital once a generation, or once every 25 years (approximately a generation), let us be honest and do it directly, but to include such a periodic direct tax on capital or wealth as simply a part of our estate-gift tax law applicable to transfers is deceitful at best. The basic principle behind our estate tax law, and of all federal, state and foreign death taxes that I know of, is to tax only actual transfers of property interests, and not, by indirection or otherwise, to tax continuous ownership by one person for too long a period of time—or to tax transfers that were never made but would have been made if the original transferor had made a different disposition of his property that the advocates of the new proposals deem more appropriate for revenue generating purposes. No nation that I know of imposes such an additional death tax on direct transfers which skip one or more generations.

The imposition of the rough equivalent of a transfer tax once every generation, or roughly once every 25 years (regardless of whether an actual transfer is made during that generation or 25-year period), would be, I submit, entirely arbitrary, and the Treasury proposal would be even more arbitrary and unfair than a capital tax imposed every 25 years (or every generation) or than the existing GSTT as applied to generation sharing schemes, since it would be imposed as an immediate second tax on the death of the original decedent or parent in the case of outright transfers to grandchildren, rather than on the later death of the "skipped" child. Such a periodic capital tax could only be predicated on the rationale that the "normal" or "appropriate" or "proper" or "preferred" disposition for every decedent to make is to leave his property to a member or members of the immediately succeeding generation—and that any other disposition (with certain exceptions, including transfers to the spouse) is abnormal or tainted. But such a concept (or indeed any concept) of what is "normal" is purely arbitrary. The "normal" disposition should rather be regarded as disposing of one's own property as one sees fit, subject to the rights of actual dependents, creditors, the surviving spouse, etc.

The notion inherent in the new proposals of a "normal" disposition clearly breaks down entirely when the decedent has no descendants and leaves his or her estate to unrelated persons. The American Law Institute proposal, unlike that of the Treasury Department, acknowledged this by providing an exception to its proposed GSTT in the case of transfers to persons other than relatively near relatives, regardless of age, although this would mean in turn discriminating in favor or unrelated or distantly related persons, who in most cases are not dependent in any way on the decedent. The typical state inheritance tax law operates in exactly the opposite direction, with bequests to non-relatives bearing a higher rate of tax than bequests to relatives.

If the advocates of the new proposals which in effect would include a special added tax on direct transfers to the second or third generation were consistent in their reasoning as to the fairness of taxing wealth every generation, they would exempt altogether from the estate tax transfers to the decedent's siblings or other members of his or her own generation. No one has ever advocated any such general exemption, however, notwithstanding the fact that taxing such transfers will presumably result in the imposition of two taxes during a single generation. Consistency with the concept of collecting a "normal" capital tax on the average of about every 25 years would also appear to require the imposing of death taxes at a higher

than normal rate on the death of a decedent who lives to a very ripe old age (since presumably he or she was able to hold the property for a longer period of time after it was last previously subjected to a death tax), and also at a higher than normal rate where the property passes to a recipient who is younger than most members of his or her generation (again since he or she might be expected to live longer than most members of the same generation and hence the property is less likely to be subjected to another tax in the relatively near future). Yet no taxing system that I know of has ever been adopted which deviates from neutrality to the extent of imposing such a penalty against abnormally old decedents or abnormally young recipients.

The proposed flat rate of the Treasury's substitute GSTT would be 44 percent in the case of decedents dying in 1984 through 1987. The American Law Institute's proposed rate (technically it would operate as a "denied credit" rather than an extra tax, but the effect would be the same) would be the transferor-decedent's marginal rate, which could be as high as a full 55 percent in the event of death of a wealthy person dying before 1988. On the other hand, if a parent dying in 1984-1987 leaves property to his or her child, who in turn dies in or after 1988 (when the maximum regular estate tax rate will be only 50 percent) and leaves the property to his or her own children, even if the child is worth billions, the additional federal tax payable on the child's death in 1988 or later would never exceed 34 percent (i.e., 50 percent minus the 16 percent maximum credit for state inheritance taxes).

It should also be borne in mind here that the GSTT payable under the new proposals as applied to a direct transfer to a grandchild would be payable on the death of the original transferor-decedent, whereas the regular estate tax which would have been payable on the child's death if the property had been left to the child (instead of the grandchild) would not have been payable until such child's death. The "present" value at the time of the parent's death of the tax thus saved on the child's death will always be relatively small, even where the child is relatively old at the time of the parent's death.

In other words, if we use the standard based on the length of a "generation" as being 25 years, as it is under present law and would be under the new proposals, and assume that "fairness" requires a tax on wealth or capital every 25 years, the tax otherwise payable on the child's death (25 years after the original transferor-decedent) has a "present" value on the death of the original transferor-decedent, based on the IRS's presently used 10 percent compound interest-discount tables, of only 9 percent of the amount of such tax. In other words, even if it is assumed that the child would be in the full 50 percent top bracket if he (rather than the grandchildren) received the property, then if that tax otherwise payable in 25 years is in effect prepaid now on the death of the original transferor 25 years earlier, as would be required in the case of a direct transfer to grandchildren under each of the new proposals, such prepayment (GSTT) should be imposed at a rate of at most 9 of 50 percent, or $4\frac{1}{2}$ percent of the value of the transferred property.

It should be emphasized that the revised GSTT under the new proposals would apply even if all the transferor's children predeceased the transferor and he or she was survived only by grandchildren as the sole natural objects of his or her bounty—a clearly absurd result. Contrary to the statement made in the Treasury proposal, our present federal tax system is neutral and does not "encourage testators to pass over their children in favor of their grandchildren and great grandchildren." But an inevitable effect of the new proposals would be to tax a direct or outright transfer to a grandchild (or other person more than $37\frac{1}{2}$ years younger than the transferor) at a higher total rate than a direct or outright transfer to a child (or other person less than $37\frac{1}{2}$ years younger than the transferor).

In other words, both the effect and clear intention would be to penalize transfers to people who are relatively young at the time of transfer—presumably because of the likelihood of their living long enough so that another estate tax is not apt to be imposed on the same property in the succeeding 20 to 40 years. I submit that the federal tax law should be neutral, and should not favor transfers to children (or the relatively old) over those to grandchildren (or the relatively young) any more than it should favor transfers to grandchildren over those to children. Indeed, the states which impose an inheritance tax on property received by heirs and devisees (rather than an estate tax on the overall property passing from the transferor) nearly all treat children and grandchildren alike and put them in the same class for purposes of determining rates and exemptions.

In several of the eleven illustrative examples contained in the Treasury proposal, the Treasury asserts that its proposed GSTT will almost never result in total taxes (including the GSTT) being greater than under present law or than the total tax that would be paid if the parent instead left the property to a child, who in turn

leaves it to the grandchildren with a second tax being payable at that time. It arrives at this conclusion by invariably assuming that the child has as large an estate as the parent, and will therefore be in as high a marginal estate tax bracket as the parent. This, I submit, will be contrary to actual facts in the vast majority of cases. Thus, where the transferor is a person of considerable wealth, his or her children are seldom as successful as business persons or investors as their parent(s). They may be imprudent, extravagant, spendthrift, lazy or just unlucky, but at any rate in one way or another they may dissipate all or most of what they receive. Furthermore, and more important, most parents produce more than one offspring, so that whatever is left of what the parents owned after the payment of their estate and inheritance taxes is generally shared by more than one child. As an illustration, assuming death of the children not earlier than 1987 when the \$600,000 estate-gift tax exemption equivalent will be fully phased in, and assuming that the children have very little of their own other than what they receive from their parent (the transferor), a transferor with two married children can leave in the aggregate about \$2½ million to such children without any estate tax on the children's (and their spouses') subsequent deaths—assuming that each of the children or his or her spouse, by judicious use of marital deduction, leaves a taxable estate of only half of what such child and his or her spouse collectively received from the transferor. The corresponding figure instead becomes about \$5 million if there are four children in the family rather than two. Thus no estate tax saving whatever can result from generation skipping under these circumstances.

It should further be noted that once the relatively large flat exemption provided for under each of the new proposals has been used up, the GSTT under the new proposals would apply to all generation skipping bequests, however small—even a bequest, for example, of \$1,000 to a grandnephew (or unrelated person more than 37½ years younger than the transferor) who has no means whatever, and whose parents are dead or likewise have no means whatever.

Another inherent cause of unfairness in the new proposals (which is less of a problem under the existing GSTT law), is their simplistic assumption that each member of one generation will die before any member of the next generation. Thus apart from the GSTT, only if the child dies before the grandchild would any saving in estate tax result from generation skipping and the leaving of property to grandchildren rather than children. But actuaries have established that, for example, over 30 percent of America's living males will die before their mothers. If a transferor leaves property directly to a grandchild (rather than the child), and the grandchild then dies before its parent, then even if there were no GSTT in effect, a second estate tax would be payable sooner (i.e., on the grandchild's death) than would be the case if the property were instead left to the child. Indeed, if the property were left to the child and the grandchild predeceased him or her, then in nearly all cases no tax would have been payable at all on the grandchild's death.

The existing GSTT, whatever its faults, seeks to remedy an apparent inequity by imposing a special tax on the death of a child who was left a property interest (usually the income for life) by its parent which was insufficient to subject such property to the regular federal estate tax on such child's death. The new proposals, on the other hand, would instead arbitrarily impose a special added tax payable on the parent's death even though no interest whatever in the property is left to his or her children. There is simply no economic or moral justification for such a discriminatory levy.

STATEMENT OF THE MISSOURI BAR

There are now bills pending in Congress to repeal the generation-skipping transfer tax. The Missouri Bar supports retroactive repeal of this tax, because the current law is too complex, unenforceable, unfair and ineffective.

Chapter 13 of the Internal Revenue Code was added by the Tax Reform Act of 1976. A transition rule postponed the effective date until January, 1982, and ERTA further postponed the effective date until January, 1983. The tax has been in effect since January, 1983.

The primary objection to the tax is that it is too complex, resulting in an inability of taxpayers and their advisors to understand the law and compute the tax. This reduces and/or eliminates voluntary compliance, which is the basis of the entire self-assessment tax system. The complexity of the law is underscored by the fact that in the years since the law was first enacted, there have been no regulations issued regarding tax computation.

A second objection to the tax is that enforcement of the law is beyond the means of the Internal Revenue Service. To fully enforce the collection of the tax, the Service must keep records of all "beneficiaries" of generation-skipping transfers as well as know when each interest terminates, when distribution occurs, and when interests under the trusts are disclaimed or assigned.

The law also impacts primarily on those middle income citizens or those of "moderate" wealth. While Congress intended to affect "wealthier" Americans who use generation-skipping devices, the practice has proven otherwise. Only wealthier Americans can afford to circumvent Chapter 13 by completely skipping younger generations in estate planning. It is the "moderate" Americans who cannot afford the luxury of "layering" who must contend with Chapter 13.

While several proposals have been advanced to improve the current law, none will completely cure all of the problems created since its enactment. It is The Missouri Bar's position that such changes will lead only to new problems and will do little to solve the original problems created by the Chapter 13 system. Only a retroactive repeal will fully eliminate all of the problems.

We therefore urge the repeal of this law retroactive to its effective date of January 1, 1983.

(Approved by Missouri Bar Board of Governors, May 4, 1984.)

RENNINGER, SPEAR & KUPITS,
Doylestown, PA, July 27, 1984.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth
House Building, Washington, DC.

DEAR MR. SALMON: Although I would like to submit a statement at the hearings, I cannot afford the time of preparation and of going to Washington.

I am a suburban practitioner with 30+ years at the Bar.

My views are:

1. The existing legislation is essentially fair in concept.
2. It is prolix and complicated. It frightens experienced practitioners. One is not sure it applies or what you have to do to avoid it undermining a good plan by some interpretation of that law.

The law should not be the private turf of some practitioners. Most people do not have nor can afford that kind of "expert" practitioner. Such practitioners tend to exist around "money" centers and are not available to the average person to whom this law applies also.

3. Exclusions by number sums such as the Treasury's suggestion of exemption amounts are Draconian—one dollar over or under and "Bang".

4. This legislation should not be a vehicle of the interests requiring the expense of independent trustees or bank fiduciaries. It has been my experience that most families prefer to manage their own affairs. This is true particularly of farm families.

5. Direct generation-skipping should be left alone. Many family reasons suggest such transfers are not tax motivated. Many grandparents are subject to the suggestion that the grandchildren who are "starting out" have some help in the here-and-now and now down the road when Mom and Dad are gone. I think congressional support of such transfers promotes the economy generally and not the estate community, a limited constituency.

Very truly yours,

JOHN S. RENNINGER.

NORTHWESTERN UNIVERSITY SCHOOL OF LAW,
Chicago, IL, August 17, 1984.

JOHN J. SALMON, Esq.,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth
House Office Building, Washington, DC.

DEAR MR. SALMON: This letter is written in response to the announcement of a public hearing to be held on September 13, 1984, or review proposals to simplify the generation-skipping tax imposed by Chapter 13 of the Internal Revenue Code. In accordance with that announcement, I am enclosing five copies of this letter, of which I have also sent a copy to Congressman Rostenkowski.

It is clear that existing generation-skipping provisions are unduly complicated. Because of this, most lawyers, trustees and accountants do not fully understand Chapter 13 and the statutory provisions are virtually non-administrable. The recent

Treasury proposals are a step in the right direction but would still involve complex problems of administration. I suggest a simpler solution to the generation-skipping problem—the enactment of what would amount to a federal rule against perpetuities. In this connection it may be worth noting that the objectives of the rule against perpetuities, as developed in England over a period of more than 200 years, were not dissimilar to those sought to be achieved by a generation-skipping tax.

My suggestion is the imposition of a tax on the privilege of holding property in trust—or by way of a life estate, successive life estates, or a term or terms for years—for 25 or 30 years or more. Thereafter, an additional tax would be imposed every 25 or 30 years on the privilege of continuing thus to hold the property. I suggest a tax on the "privilege of holding the property," as distinguished from a tax on the property itself, to avoid problems of apportionment. As you are well aware, the federal estate tax itself is a tax on the privilege of transmitting property.

Since, in a few situations, the foregoing suggestion could give rise to inequities, there should be exceptions to the tax proposed, but these should be limited to avoid complexity. Probably no tax should be imposed while a spouse or a disabled or incompetent descendant is the sole beneficiary of a trust, life estate or term for years. If, however, a trust, a new life estate or a term continued for 25 or 30 years after the death of the spouse or disabled or incompetent person, the tax should be exacted at the expiration of that period.

The only other exception which would seem necessary would be the allowance of an exemption where the value of the property held in trust, for life or for years was small. Such an exemption could be similar to the "exemption" resulting from the federal estate or gift tax credit, but should depend on the value of the particular property held in trust, for life or for years. In the interest of simplicity, the exemption should be available without regard for other property held by or for the benefit of the beneficiary unless "multiple trusts" have been created by the same person or his/her spouse for the same beneficiary. In such cases, the "multiple trusts" could be treated as one for purposes of any exemption.

I respectfully urge you to give this proposal careful consideration. It would afford a workable solution to a problem which existed in 16th century England. It would not jeopardize the trust as an extremely useful dispositive device, since, if my memory is correct, statistics developed some years ago by the American Bankers Association indicated that the duration of the average trust was then only about 18 years. Some tax experts are likely to object that the proposal is simplistic. But sometimes a little simple injustice is less unjust than a great deal of complex justice.

Sincerely,

DANIEL M. SCHUYLER, *Professor of Law Emeritus.*

STATEMENT OF THOMAS P. SWEENEY, RICHARDS, LAYTON & FINGER

This statement is being prepared by Thomas P. Sweeney on his own behalf and represents his own position with respect to the status of the current Chapter 13, Title 26 of the U.S. Code, as well as the proposals contained in H.R. 6260 and H.R. 6261.

I. POSITION WITH RESPECT TO PRESENT CHAPTER 13

I join the number of professional groups who actually testified at the hearings on October 2, 1984, in supporting outright retroactive repeal of present Chapter 13. Chapter 13 has been with us for over eight years and the Internal Revenue Service has not been able to promulgate regulations or issue any rulings with respect to its operation. Practitioners have found it almost impossible to deal with, and it is my fear that the provisions of present Chapter 13 are more honored in the breach than in attempts to comply with it. Accordingly, the statute which has been found to be inadministerable by the Internal Revenue Service, the entity charged with its administration, and by practitioners should not continue to be imposed upon the tax paying public. The continued existence of Chapter 13 does a great deal of damage to respect for our self-assessment tax system and its immediate repeal is necessary in order to avoid further undermining the self-assessment tax system.

II. SHOULD THERE BE A SUBSTITUTE FOR CHAPTER 13?

It is my belief that the current estate and gift tax provisions adequately satisfy the need for transfer taxes to be asserted upon the transfer of property either during lifetime or at death. There is no need or justification for a third layer of transfer taxes, with the result that it would be my recommendation that no new

Chapter 13, generation-skipping transfer tax, be substituted in lieu of the current Chapter 13. In most instances, the transfer of capital is to the generation immediately below the transferor. In those few instances where the transfer of capital is to generations beyond the generation immediately below the transferor or the transfer gives a limited interest to the generation immediately below the transferor, there does not seem to be justification to take the capital out of the private sector and place it in the public sector at the time of the termination of the interest of succeeding generations.

The revenue to be generated by the generation-skipping transfer tax is de minimis in comparison to the total revenue that is needed to operate the country with the result that one wonders why Congress denotes any attention to generation-skipping transfers. It would appear that Congress could devote its attention more productively to other sources of revenue.

Further, one wonders why Congress would devote its attention to confiscating capital out of the private sector at a time when the economy is just rebounding from a recession and capital funds are desperately needed in the private sector to continue the recovery.

III. SUBSTITUTE FOR PRESENT CHAPTER 13

H.R. 6260 and H.R. 6261 have been introduced for purposes of comment. The proposal by the Treasury Department is contained in H.R. 6260, and the so-called "ALI Proposal" is contained in H.R. 6261.

If it is absolutely necessary to have a substitute for Chapter 13, then I would favor the proposal contained in H.R. 6260 subject to the same reservations and changes suggested in the testimony of Malcolm A. Moore on behalf of the American College of Probate Counsel. The exemption approach of H.R. 6260 is more administrable and easier understood than the credit approach of H.R. 6261.

Since the introduction of these two Bills, there has not been sufficient time to devote adequate study to all the problems which they create. However, it should be noted that with respect to H.R. 6260, the exemption level of \$1,000,000 does not seem to come close to what Congress really considers a definition of "wealth." In the revision to the estate tax rates contained in the Tax Reform Act of 1984, Congress had fixed on a level of \$3,000,000 as being where the top marginal rate will commence until 1988. Accordingly, it would appear that an exemption of at least \$3,000,000 would be appropriate and in accordance with what Congress has found as "wealth."

The credit approach of H.R. 6261 which limits the credit to \$417,000 should likewise have an increase to where it would have an equivalent of \$3,000,000 of transfers if it was to be adopted.

IV. DIRECT GENERATION-SKIPPING TRANSFERS

Chapter 13 does not currently provide for a tax on direct generation-skipping transfers. Both H.R. 6260 and H.R. 6261 impose such a tax.

When Chapter 13 was originally adopted in 1976, there was no perceived abuse with respect to direct transfers which were subject to an estate tax if they took place at death or a gift tax if they took place during the lifetime. There seems to be no justification for a double tax to take place on direct transfers when those transfers are to a generation more than one below the generation of the transferor. Such a course of action constitutes pure confiscation of capital from the private sector and does make economic sense. It goes far beyond the perceived evil which Congress saw in enacting the present Chapter 13. Further, as the examples set forth in the testimony of Malcolm A. Moore of the American College of Probate Counsel illustrate, the effect of the double taxation on direct transfers can result in a tax in an amount equal to as much as almost 300 percent of the amount ultimately received by the transferee. Such outlandish transfer tax rates do nothing more than discourage ingenuity in a capitalistic system and are very destructive of the system itself.

V. TAX EXCLUSIVE OR TAX INCLUSIVE

The Treasury proposal in H.R. 6260 applies a tax inclusive computation on generation-skipping transfers except in the case of direct transfers. The ALI proposal, H.R. 6261, adopts a tax exclusive approach for direct skips and taxable distributions, but not for taxable terminations.

The current gift tax is computed on a tax exclusive basis, that is, the amount of the tax is not included in the amount of the transfer subject to the tax. On the other hand, the estate tax is computed on a tax inclusive basis. If there is to be a

generation-skipping transfer tax, in order for it not to be so burdensome and so confiscatory, it makes no sense for it to be on a tax inclusive basis. All aspects of the generation-skipping transfer tax should be on a tax exclusive basis so as to avoid the extra burden and the overall confiscatory tax rate which would otherwise be imposed.

VI. GENERATION-SKIPPING TAX ON INCOME

The Treasury proposal, H.R. 6260, would impose a generation-skipping transfer tax on income distributions. This is unlike the present Chapter 13, and I would urge the retention of the income exception. First of all, the exemption of income from the generation-skipping tax would simplify the administration of the tax and compliance with the law. The Trustee of a generation-skipping transfer trust would not have to be concerned about filing a generation-skipping tax return and paying a tax when only distributions of income were made to a beneficiary during a particular year.

Also, the imposition of a generation-skipping transfer tax on distributions of income creates a rather large effective tax rate on such distributions which is well in excess of the current maximum estate and gift tax rates and the current income tax rate. There seems to be no justification for having an effective rate which is far in excess of what Congress has set as maximum rate.

VII. CONCLUSION

In summary, I would state that it is perfectly clear that current Chapter 13 is unadministerable and is not being honored and should be repealed immediately. Further, it is my position that no alternative need be substituted for current Chapter 13. However, if an alternative is to be adopted, I would favor the approach taken by the Treasury in H.R. 6260 subject to the following modifications:

- (1) Increase in the exemption;
- (2) Reduction in rate;
- (3) Elimination of the tax on direct generation-skipping transfers;
- (4) Adoption of a tax exclusive rather than a tax inclusive approach; and
- (5) No generation-skipping tax to be asserted on distributions of income.

